Statement on Monetary Policy

AUGUST 2023

RESERVE BANK OF AUSTRALIA

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Contents

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Overview

Inflation in Australia continued to decline in the June quarter from its peak at the end of last year, but it remains too high. Headline and trimmed mean inflation were around 6 per cent in year-ended terms. Goods price inflation eased further in the quarter, and by more than had been expected, especially for consumer durables. An easing in global cost pressures and a slowing in domestic demand growth are flowing through to domestic goods price inflation. By contrast, services price inflation – especially for market services and rents – remained strong.

The outlook for inflation is little changed from three months ago. CPI Inflation is forecast to continue to decline, to be around 3¼ per cent at the end of 2024 and back within the 2–3 per cent target range in late 2025. Further easing in goods price inflation is expected to drive the decline in inflation over the year ahead. However, demand continuing to exceed supply in parts of the economy and domestic cost pressures, due to the associated ongoing tightness in the labour market and rising energy costs, are expected to see inflationary pressures persist for a while, especially for services. At the same time, rent inflation will remain high, particularly as high population growth in recent quarters has added demand to an already tight rental market.

The labour market is still tight, although conditions have eased a little. The unemployment rate has been close to 3½ per cent for the past year, and strong population growth has continued to support employment growth over recent months. However, a range of indicators of labour demand, such as job vacancies, have declined from their peaks and the underemployment rate has risen a little over recent months. Firms in the Bank's liaison program have also reported an improvement in labour availability, supported by the arrival of foreign workers.

In response to the tight labour market and high inflation, wages growth picked up to its highest rate in a decade. While more timely indicators suggest wages growth was steady in the June quarter at around 3½ to 4 per cent, wages growth is expected to strengthen in the second half of the year because of the ongoing tightness in the labour market, increases in award and minimum wages, and recent developments in public sector wage policies. The inflation forecasts assume labour productivity growth, which is currently very weak, will return to its pre-pandemic trend over the next year or so; this will be needed for the current rate of growth in nominal wages to be consistent with the inflation target.

Growth in economic activity has been subdued this year, contributing to a better balance between supply and demand. Consumer spending has slowed considerably over the past year as cost-of-living pressures, the rise in interest rates and the earlier decline in housing prices all weighed on demand. Despite slower growth, the level of economic activity in Australia is still around its pre-pandemic trend.

Growth in the economy is expected to remain subdued over the period ahead, reaching a trough of around 1 per cent at the end of 2023, before gradually picking up to around

2¼ per cent by the end of 2025. Employment is expected to continue to increase over the forecast period, but at a slower pace than the working-age population. In response, the unemployment rate is expected to start picking up gradually in the period ahead, to reach 4½ per cent by late 2024. These forecasts are broadly as they were three months ago. They embed a higher profile for the cash rate over the forecast period compared with the May *Statement*, including because of increases in the cash rate in May and June. But there are other forces working in the opposite direction, including from higher-than-expected population growth and an earlier-than-expected recovery in the established housing market.

The housing market has turned around earlier than anticipated because of the combined effects of stronger demand – buoyed partly by strong population growth – and limited supply. Housing prices have increased in recent months across most capital cities. Construction activity for new dwellings continues to be limited by capacity constraints because of labour shortages and a tightening in financial conditions. For developers, cash-flow constraints and an increase in insolvencies could create further delays in completions. The pipeline of existing work is expected to support construction activity as capacity constraints ease, despite relatively weak demand for new construction.

The outlook for the domestic economy is subject to a range of uncertainties. Household consumption remains a key source of uncertainty. Weakness in household consumption could persist for longer than expected if weak growth in aggregate real disposable income and a rising unemployment rate have larger-than-expected effects on spending, especially on households with high debt and low savings. Alternatively, it is possible that consumer spending could recover more quickly than currently forecast, particularly if the labour market is more resilient than expected, and as real incomes start to improve as inflation declines. Higher housing prices are expected to support household consumption, but the extent of the effect is uncertain and will be influenced by how housing turnover responds.

There are both upside and downside risks to the inflation outlook. Inflation could be more persistent than forecast if wages growth is stronger than expected, if productivity growth fails to recover or if profit margins widen as input costs decline, even as the economy slows. On the other hand, declines in global cost pressures could pass through more quickly to domestic prices than assumed, supported by weak consumer demand. Global disinflationary pressures could also be greater than assumed, particularly in the context of recent weaker-than-expected growth and low inflation in China.

Globally, headline inflation has declined further in most advanced economies, and by a little more than earlier expected in some cases. But core inflation remains well above central banks' targets and is proving to be persistent. Labour market conditions in advanced economies remain tight, which is supporting strong wages growth, particularly in Europe. Weak productivity growth also remains a concern for the inflation outlook in most of these economies.

Central banks in most advanced economies have increased policy rates further over recent months in response to concerns that inflation could be more persistent than expected. According to market expectations, policy rates for many central banks are close to their peaks, though a few are expected to raise rates a bit further. Concerns around US banking stresses have eased since earlier in the year, which has supported a narrowing in credit spreads. Even so, credit growth in the United States and Europe has continued to slow, consistent with the significant tightening in monetary policies.

In China, the pace of economic recovery has eased following an initial strong rebound after the lifting of COVID-19 restrictions at the end of last year. The outlook for the Chinese economy has been revised lower over recent months, but growth in China is still consistent with the authorities' target of around 5 per cent in 2023. The outlook will depend on how the recovery in household consumption continues to play out, and the scale and effectiveness of any policy support, particularly in the property sector, which has deteriorated further this year. Iron ore prices have been resilient reflecting the expectation of some further targeted stimulus for the property sector. By contrast, thermal coal prices have declined, partly because of weak industrial demand in China.

Overall, growth in Australia's major trading partners is expected to be around 3¼ per cent in 2023 and 3 per cent in 2024, which is well below pre-pandemic longer run averages and lower than forecast three months ago. The downward revision partly reflects recent slower growth in China. On the other hand, growth in major advanced economies has been revised up slightly for 2023, as the trough in growth in these economies is now expected to occur a little later than previously thought.

In Australia, monetary conditions have tightened further over recent months. Banks have increased both lending and deposit rates further, but the overall increase in this tightening phase has been less than the increase in the cash rate. Credit growth has stabilised recently, though at a noticeably lower level than late last year. While demand for new housing loans remains well below its early 2022 level, it has increased a little since earlier this year alongside increases in activity in the housing market and in housing prices. The Australian dollar is broadly around its levels in May on a trade-weighted basis.

Over the course of this year, the Reserve Bank Board has taken further steps to ensure inflation returns to the target range within a reasonable time. The Board raised interest rates by 25 basis points at the May and June meetings, to provide greater confidence that inflation would return to target over the forecast horizon. At that time, the flow of data had indicated that upside risks to inflation had increased, and the Board responded to the shift in risk by raising policy rates. This brought the cumulative increase to 400 basis points during the current tightening phase.

At the subsequent meetings in July and August, the Board decided to hold rates unchanged. It did this to provide time to assess the impact of the increases to date as well as the outlooks for inflation and the economy, and the associated risks.

At both the July and August meetings, the Board considered the option of raising rates further. The case to increase the cash rate further centred on the fact that inflation was still too high and that it was expected to remain above the target until mid-2025. Also, demand continues to exceed supply in some parts of the economy, and labour market conditions are still tight, which is conducive to above-average increases in prices and wages. At the same time, productivity growth remains weak, which is contributing to strong growth in costs. While goods inflation has slowed, services inflation remains strong. In some comparable economies, core inflation (especially for services) has proven to be stickier than anticipated and policy rates have been raised further in response. In these economies, policy rates are generally at a higher level than the cash rate in Australia, yet Australia's inflation rate is at least as high. These factors highlight the risk that inflation could be above the target range for an even longer period than currently forecast, which would increase the probability of higher inflation expectations becoming embedded. Tightening policy further could provide some further insurance against these upside risks to inflation.

Notwithstanding these arguments, the Board judged that the stronger case was to hold the cash rate steady in July and August. The Board is mindful that monetary policy has been tightened significantly in a relatively short period and that the level of the cash rate is restricting economic activity. Growth in the economy has slowed and policy is working to establish a better balance of supply and demand in the economy and thus to bring inflation down. The data in recent months have confirmed that inflation is moving in the right direction and are consistent with inflation returning to the 2–3 per cent target range over the forecast period.

The Board is also mindful that the typical lags of monetary policy mean that the full effects of the interest rate increases to date on demand, the labour market and inflation are yet to be seen. Many households are experiencing a painful squeeze on their budgets, reflecting the high cost of living but also the fast pace of the interest rate increases so far. The Board has also been conscious of the economic and social benefits of preserving as much of the gains in the labour market as possible. These considerations meant that the Board could take some more time to assess how the economy and risks to inflation and employment are evolving.

The Board's current assessment is that the risks around the inflation outlook are broadly balanced. But it recognises that the crystallisation of upside risks would increase the likelihood of inflation staying high for longer and a rise in medium-term inflation expectations. If inflation expectations were to rise, the result would be even higher interest rates, a more substantial slowing in the economy and a larger rise in unemployment to bring inflation back to target. So far, medium-term inflation expectations remain consistent with inflation returning to target and it is important that this remains the case.

The Board's priority is to return inflation to target. High inflation makes life difficult for people and damages the functioning of the economy. And if high inflation were to become entrenched in people's expectations, it would be very costly to reduce later. Some further tightening of monetary policy may be required to ensure that inflation returns to target in a reasonable timeframe, but that will depend upon the data and the evolving assessment of risks. The Board will continue to pay close attention to developments in the global economy, trends in household spending, and the outlook for inflation and the labour market. The Board remains resolute in its determination to return inflation to target and will do what is necessary to achieve that outcome.

1. The International Environment

Globally, headline inflation has continued to ease as energy prices have remained much lower than their peaks last year. However, core inflation has declined by much less, with services price inflation proving to be more persistent than many central banks in advanced economies had previously expected. This is consistent with demand remaining strong relative to supply, and labour markets remaining tight. Unemployment rates are still very low, with tightness in advanced economy labour markets easing only gradually to date. Growth in nominal wages and unit labour costs remains strong; in some economies, the recent pick-up in wages growth in an environment of weak productivity growth could further delay the return of core inflation to target.

Global economic growth has slowed as contractionary monetary policy and cost-of-living pressures have continued to weigh on demand, although activity in some advanced economies has been a little more resilient than had previously been expected. Conditions in the services sector remain relatively resilient, while conditions in the manufacturing sector have continued to weaken in a number of economies as household consumption has rebalanced away from goods into services. The conditions facing consumers have started to improve because of recovering real household disposable incomes, and a return to positive housing price growth in some advanced economies. Global growth is nevertheless expected to remain below average over the next two years.

The economic outlook for China has been revised lower compared to three months ago. In China, the economic recovery has slowed after the initial rebound from the COVID-19 lockdowns in late 2022. Household consumption growth has been relatively resilient but there has been a sharp deterioration in property sector conditions. Chinese authorities have acknowledged 'insufficient domestic demand' and have signalled more policy support could be provided for the property sector and household consumption.

Central banks in most advanced economies have increased policy rates further and several have indicated that additional policy tightening is likely to be required to return inflation to target. Market participants' expectations for the paths of policy rates have increased over the past few months, driven by signs that inflation may be more persistent than expected. Government bond yields have increased in line with policy rate expectations. Meanwhile, credit spreads narrowed and equity prices increased following the resolution of the US debt limit and as concerns around US banking stresses eased. However, credit growth in the United States and Europe has continued to slow, consistent with their significant tightening of monetary policy. The US dollar is little changed over recent months.

Inflation has fallen further from its peaks, but services inflation remains persistent

Globally, headline inflation remains high, but it has eased to be closer to central banks' targets in some advanced economies. Inflation has also declined in the largest emerging economies in Asia; inflation is especially low in China, both by global standards and relative to the central bank's target (Graph 1.1).

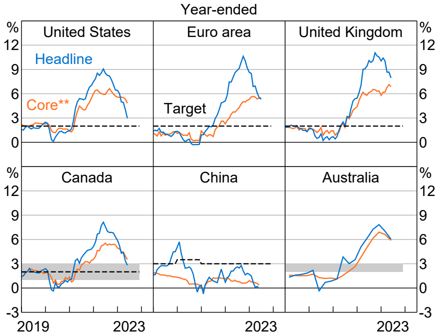
Declines in energy prices have been a key driver of the easing in headline inflation (Graph 1.2). Since the May *Statement*, thermal coal and natural gas prices have continued to decline, though oil prices have increased in response to further OPEC output cuts. Nevertheless, energy prices remain well below their levels of a year ago and are likely to continue to subtract from year-ended headline inflation over the coming months (Graph 1.3). Global food price inflation remains high, but many agricultural commodity prices (including prices of farm inputs such as fertiliser) have declined since late 2022. That said, the potential for future supply disruptions – including related to the emerging El Niño weather pattern and blockages of Black Sea exports from Ukraine – remains an upside risk to some agricultural prices, particularly in emerging market economies.

In contrast to the easing in headline inflation, core inflation is proving persistent at high levels in advanced economies. Core goods inflation has eased as demand and supply for consumer goods have moved into better balance, but in

Graph 1.1

Consumer Price Inflation*

Year-ended



* Shaded area represents target range for inflation.

** Core is trimmed mean for Australia and CPI excluding food and energy for other economies.

Sources: ABS; CEIC Data; RBA; Refinitiv.

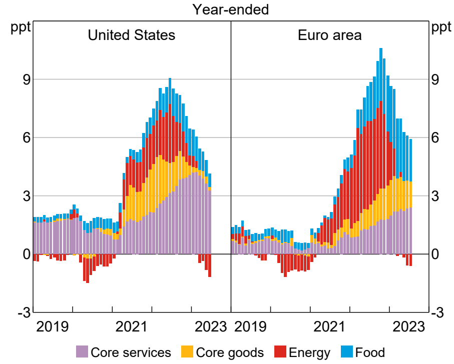
some cases this has been slower than expected. Services price inflation has eased by less, with a high degree of persistence evident for both rent and other services prices.

Rent inflation is high in most advanced economies and is also one of the largest items in CPI baskets (Graph 1.4). Rental price growth tends to be relatively persistent as both supply and demand for rental housing can be slow to adjust in response to price signals. In some euro area economies, rents are indexed to CPI, but some countries have capped the maximum increases. However, there are firm signs that CPI rent inflation has peaked in the United States, with the rate of price increases in new rental agreements slowing considerably as the supply

Graph 1.2

Contributions to Headline Inflation

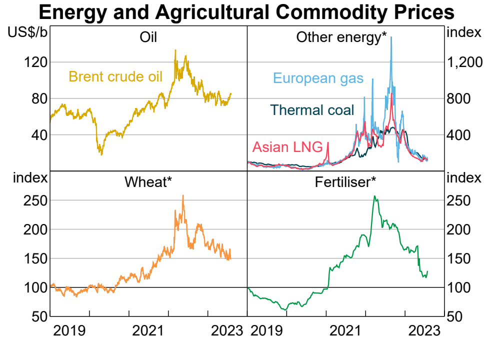
Year-ended



Sources: BLS; Eurostat; RBA; Refinitiv.

Graph 1.3

Energy and Agricultural Commodity Prices



* January 2019 = 100; indexed to SDR prices except European gas which is indexed to euros.

Sources: Bloomberg; McCloskey by OPIS; RBA; Refinitiv.

response has started to materialise. Pass-through to CPI inflation from prices in new rental agreements typically takes around a year, suggesting it will take some time for the declines in advertised rent inflation to flow through.

Inflation in the prices of non-housing services also remains high in most advanced economies, consistent with the strength in demand relative to supply and the associated strong growth in nominal wages (and unit labour costs) and no easing in profit margins. However, there is variation across economies in the trajectory of non-housing services inflation. This component of inflation has recently started to edge lower in the United States; however, it has continued to increase to very high rates in the United Kingdom, underpinned in part by particularly strong wages growth there (Graph 1.5).

Labour markets have been resilient and wages growth remains strong

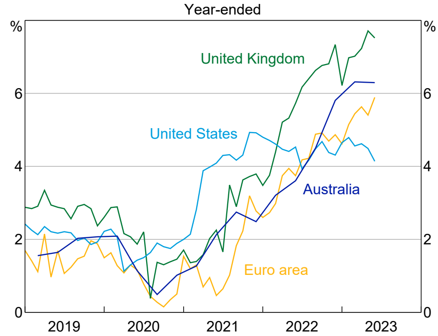
Labour market tightness in advanced economies is easing, but only gradually. Unemployment rates have edged slightly higher in some economies, but generally remain close to historical lows. Similarly, job vacancy-to-unemployment ratios have fallen from their early-2022 peaks but remain well above pre-pandemic levels in many advanced economies (Graph 1.6). Employment growth remains strong, having eased only slightly in many advanced economies over recent months. Looking ahead, central bank liaison suggests that labour market conditions will ease a little this year as demand for labour decreases and immigration and participation rates recover to their pre-pandemic levels, but labour markets are expected to remain tight overall.

Nominal wages growth remains strong and has picked up further in some economies in recent months (Graph 1.7). In some countries, particularly in Europe, additional pay increases to compensate workers for high rates of inflation are also supporting wages growth, including

Graph 1.5

Non-housing Services Inflation*

Year-ended



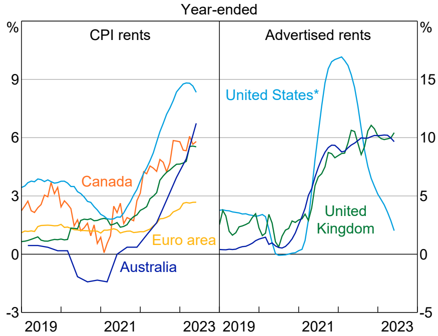
* PCE used for the United States, CPI elsewhere.

Sources: ABS; Employ America; Eurostat; Federal Reserve; ONS; RBA; Refinitiv.

Graph 1.4

Rent Inflation

Year-ended



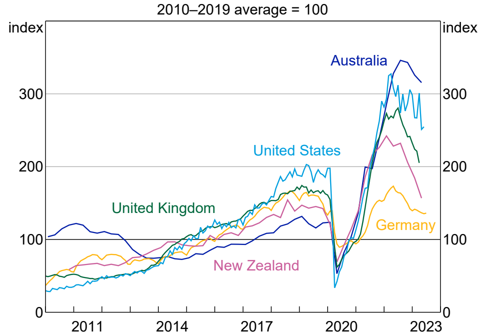
* Advertised rent inflation for the United States is the average of Apartment List and Zillow estimates.

Sources: ABS; Apartment List; CoreLogic; HomeLet; RBA; Refinitiv; Zillow.

Graph 1.6

Vacancies-to-unemployment

2010–2019 average = 100



Sources: RBA; Refinitiv.

recent and prospective increases to minimum wages. With current estimates of labour productivity growth remaining subdued in most economies, prevailing rates of wages growth remain above levels that would be consistent with many central banks' inflation targets over the medium term (Graph 1.8).

Global economic growth has been subdued in the first half of 2023

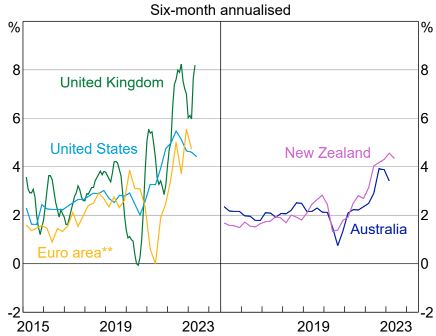
GDP growth has slowed in most advanced and east Asian economies over the past year, although the level of demand remains high relative to supply (Graph 1.9). Even so, the slowing in growth in major advanced economies has been less than previously expected, with June quarter GDP growth in the United States and the euro area both a bit above Consensus forecasts. The effects of tighter monetary policy and high inflation in these economies has been particularly evident in slowing household consumption growth. In most advanced economies, GDP per capita is around or a little below where it was prior to the COVID-19 pandemic; the United States is the main exception, with GDP per capita having recovered to around its pre-pandemic trend (Graph 1.10).

Services sector activity continues to be the main driver of growth in major advanced economies,

Graph 1.7

Wages Growth*

Six-month annualised



* Labour cost indices used where available; average earnings for the United Kingdom (compositionally controlled prior to April 2022).

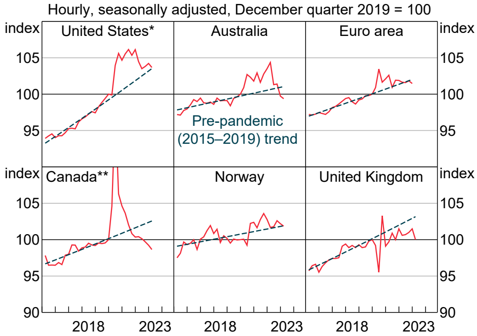
** Year-ended.

Sources: BoE; RBA; Refinitiv.

Graph 1.8

Labour Productivity

Hourly, seasonally adjusted, December quarter 2019 = 100



* Non-farm business sector.

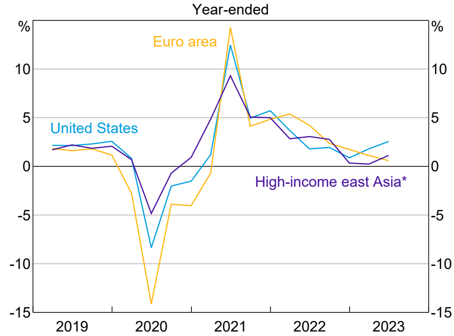
** Business sector; labour productivity peaked at 118 in the June quarter of 2020.

Sources: ABS; RBA; Refinitiv.

Graph 1.9

GDP Growth

Year-ended



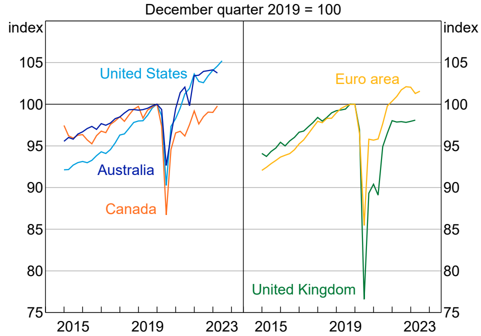
* PPP-weighted average of Japan, Hong Kong, Singapore, South Korea and Taiwan.

Sources: CEIC Data; RBA; Refinitiv.

Graph 1.10

GDP Per Capita

December quarter 2019 = 100



Sources: RBA; Refinitiv.

with goods demand and manufacturing sector activity remaining weak (Graph 1.11). Survey measures indicate that new orders in the manufacturing sector continued to weaken in a number of advanced economies in July, as did new export orders in Asia. The ongoing softness in goods demand has weighed on east Asian exports (including from China), with industrial production in the region also remaining weak.

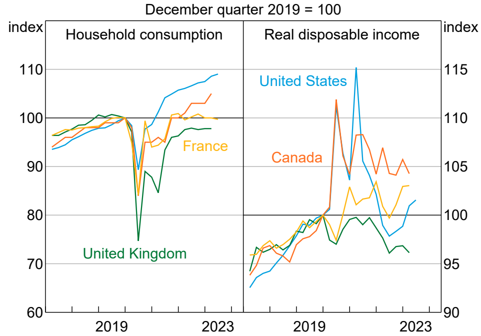
Although household consumption growth has slowed in most advanced economies in recent months, the broader post-pandemic recovery in consumption has been notably stronger in the United States and Canada than it has been in Europe. Consumption growth in some advanced economies has been supported by recovering real household income growth as nominal wages growth has remained strong and the drag from inflation has eased (Graph 1.12; Graph 1.13). Stabilising housing prices may have also supported consumption in some economies. Acting in the other direction, household saving rates are now back down to around pre-pandemic levels. There is also uncertainty about how much further the earlier boost to consumption from drawdowns of additional savings that were accumulated during the pandemic will run, particularly as not all of these savings will be invested in liquid assets that can be easily drawn on.

Residential investment has been weak in advanced economies reflecting higher interest rates. However, housing prices have stopped falling across many advanced economies, and have started to increase again in some, driven variously by strong population growth, higher incomes due to low unemployment and low supply of housing (Graph 1.14). Forward-looking indicators such as building approvals have also increased in both the United States and New Zealand, but from low levels. Business investment has recently returned to its pre-pandemic level in most advanced economies,

Graph 1.12

Consumption Indicators

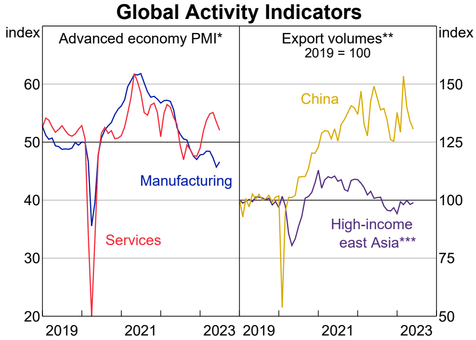
December quarter 2019 = 100



Sources: RBA; Refinitiv.

Graph 1.11

Global Activity Indicators



* Purchasing Managers' Index; PPP-weighted average of the United States, euro area, United Kingdom and Japan.

** Merchandise exports; deflated using the United States import price index for east Asia and the United States price deflator for imports from China.

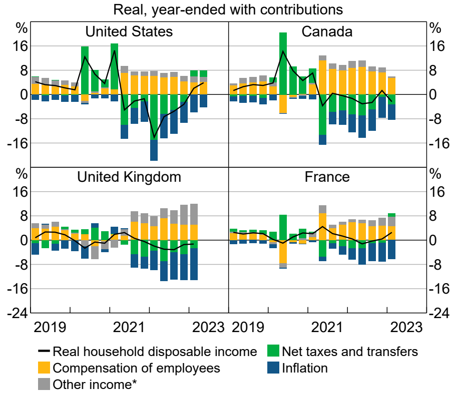
*** PPP-weighted average of Japan, South Korea, Taiwan, Singapore and Hong Kong.

Sources: CEIC Data; RBA; Refinitiv; S&P Global.

Graph 1.13

Household Disposable Income Growth

Real, year-ended with contributions



* Other income includes net property and interest income.

Sources: BEA; Insee; ONS; RBA; Refinitiv; Statistics Canada.

but is somewhat stronger in the United States, where it has now returned to its pre-pandemic trend.

China's economic growth has declined following a strong initial bounce-back from COVID-19-related restrictions …

Growth in the Chinese economy was relatively subdued in the June quarter at 0.8 per cent, following an initial strong recovery after COVID-19-related restrictions were lifted at the end of 2022 (Graph 1.15). Net exports and ongoing weakness in the property sector have contributed to slower growth. Household consumption continued to recover despite a sharp deterioration in property sector conditions, but the level of consumption remains below its pre-pandemic trajectory (Graph 1.16). Chinese authorities have recently announced a range of policy measures intended to provide some support to household consumption.

Improvement in China's aggregate labour market conditions has provided some support to consumption, with the total unemployment rate remaining broadly stable at around 5 per cent in the June quarter – close to its 2019 average (Graph 1.17). However, conditions in the labour market have been uneven, with the youth unemployment rate having doubled to almost 20 per cent since mid-2019. In contrast to most advanced economies, growth in urban household income from wages in China remains well below its pre-pandemic average, suggesting there is still considerable spare capacity in the labour market.

… alongside a significant further deterioration in property market conditions

Fixed asset investment in China continued to be supported by infrastructure and manufacturing investment in the June quarter, but real estate investment continued to subtract from growth (Graph 1.18)

Ongoing weakness in consumer confidence and uncertainty regarding the completion of homes

Graph 1.15

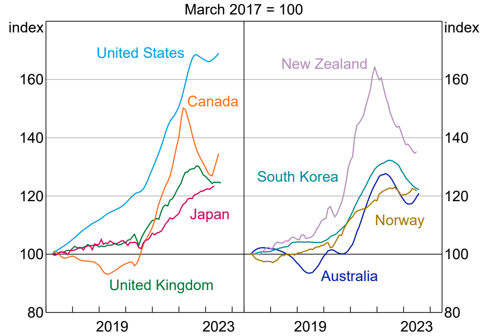
China – GDP Growth

Sources: CEIC Data; RBA.

Graph 1.14

Housing Prices

March 2017 = 100

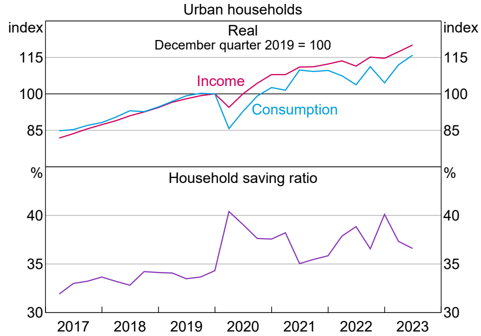


Sources: national sources; RBA; Refinitiv.

Graph 1.16

China – Household Consumption and Income*

Urban households



* Seasonally adjusted by the RBA.

Sources: CEIC Data; RBA.

under construction have reduced the demand for new housing. As a result, sales have declined materially from the March quarter as pent-up demand from the COVID-19 restrictions in late 2022 has unwound (Graph 1.19). Authorities recently signalled a more positive tone on property sector support, with a further easing of city-level home purchase restrictions likely. However, the scope and impact of these changes is still uncertain, given household confidence is low and restrictions in many smaller cities have already been eased.

Reduced revenue from falling sales has exacerbated developers' financial pressures, making it more difficult for them to complete existing projects and begin new work. This has contributed to further defaults by developers on offshore debt and a further decline in their asset prices, which have largely retraced the sharp increase that followed the reopening of the economy in late 2022 (Graph 1.20). However, developers' equity prices increased over July following the extension of some existing support measures, and expectations of further policy easing.

Graph 1.17

China – Labour Market Indicators*

Urban areas

* Seasonally adjusted by the RBA.

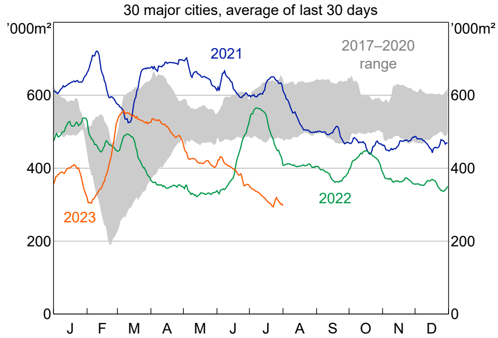
** Per capita.

Sources: CEIC Data; RBA.

Graph 1.19

China – Residential Floor Space Sold*

30 major cities, average of last 30 days



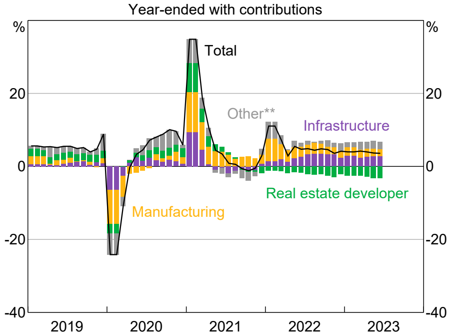
* Seasonally adjusted by the RBA.

Sources: RBA; WIND Information.

Graph 1.18

China – Fixed Asset Investment Growth*

Year-ended with contributions



* Seasonally adjusted by the RBA.

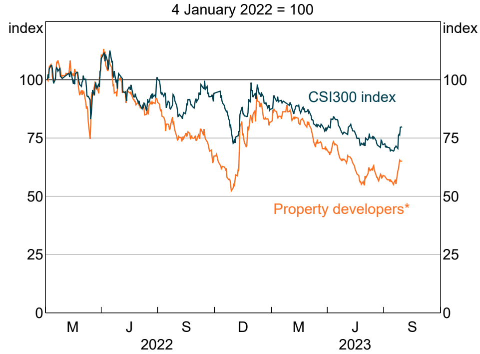
** Calculated as the residual.

Sources: CEIC Data; RBA.

Graph 1.20

China – Equity Prices

4 January 2022 = 100



* Index constituents includes all listed developers on the Hong Kong, Shanghai and Shenzhen stock exchanges with assets greater than CNY60 billion as of 2020.

Sources: Bloomberg; RBA; Refinitiv.

Chinese authorities have eased monetary policy a little further …

In June, the People's Bank of China (PBC) reduced two key policy rates – the one-year medium-term lending facility (MLF) rate and the seven-day repo rate – both by 10 basis points (Graph 1.21). Subsequently, banks lowered the five-year loan prime rate (LPR), a key mortgage reference rate, by 10 basis points. This modest easing of policy came alongside recent data which indicated the economic recovery has not been as strong as expected. This included weaker-than-expected total social financing (TSF) growth, which has moderated since March. Chinese Government bond yields have declined since the previous *Statement*, consistent with expectations of weaker economic activity, inflation and further easing in monetary policy.

The Chinese renminbi depreciated against the US dollar and on a trade-weighted (TWI) basis to its lowest level since November 2022, consistent with a widening in the interest rate differential between US and Chinese Government bonds. The PBC has implemented several measures to reduce the pace of renminbi depreciation. Since late June, the PBC has set a stronger 'CNY fix' – the midpoint of the permitted daily trading range – for the renminbi than expected by surveyed market participants (Graph 1.22). Some state-owned banks have also lowered the interest rate on US dollar deposits, which may encourage exporters to settle foreign exchange receipts in yuan, supporting the exchange rate.

… and iron ore prices have been resilient on expectations of further Chinese policy stimulus

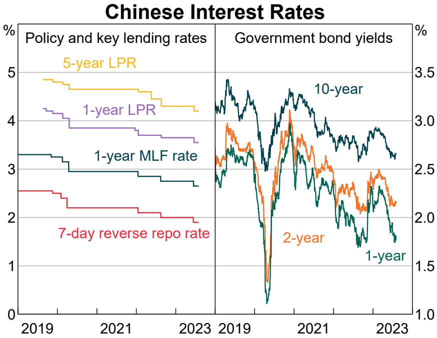
After falling earlier in the year, iron ore prices have been resilient to the weaker-than-expected Chinese activity data, driven by expectations of further policy stimulus for the property market (Table 1.1). The iron ore price has also been supported by low inventories at Chinese steel mills, while coking coal prices have been supported by restocking in China and India. Thermal coal prices have declined due to lower natural gas prices and high coal stocks, as well as weak industrial sector demand in China, despite heatwaves in Europe and north-east Asia boosting electricity demand.

The outlook for global growth has been revised a little lower and remains below average

Year-average GDP growth in Australia's major trading partners is forecast to be around 3¼ per cent in 2023 before declining to 3 per cent in 2024 (Graph 1.23). This is weaker than three months ago, with slower growth in China and an update to trading partner weights

Graph 1.21

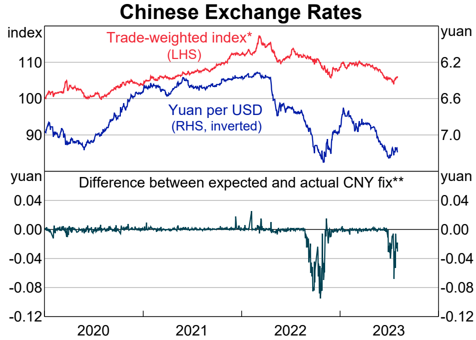
Chinese Interest Rates



Sources: CEIC Data; RBA.

Graph 1.22

Chinese Exchange Rates



* 1 January 2020 = 100.

** Negative value indicates official fix was stronger than expected by market economists, supporting the yuan against the USD.

Sources: Bloomberg; China Foreign Exchange Trade System; RBA.

Table 1.1: Commodity Price Growth[(a)]

SDR terms; percentage change

	Since previous *Statement*	Over the past year
Bulk commodities	0	−21
– Iron ore	6	−5
– Coking coal	5	26
– Thermal coal	−25	−66
– Asian LNG spot	−4	−74
– Lithium (Australian Spodumene)	−27	−30
Rural	−5	−12
Base metals	0	−5
Gold	−5	9
Brent crude oil[(b)]	15	−18
RBA ICP	−5	−21
– Using spot prices for bulk commodities	−1	−21

(a) Prices from the RBA Index of Commodity Prices (ICP); bulk commodity prices are spot prices.

(b) In US dollars.

Sources: Bloomberg; McCloskey by OPIS; RBA; Refinitiv.

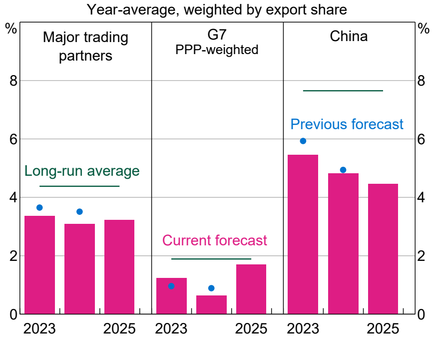
(which lowers the weight on the Chinese economy) the main drivers of the change.[1]

According to Consensus forecasts, GDP growth in major/G7 advanced economies is expected to remain subdued in 2023. They have been revised slightly higher in 2023 in aggregate as activity and labour market data have been more resilient than expected, but remain well below long-run averages. Downturns are now expected to occur later than was expected three months ago and GDP growth forecasts for 2024 have therefore been revised slightly lower. Consensus forecasts for GDP growth in east Asia excluding China are little changed for the region as a whole.

Graph 1.23

GDP Growth

Year-average, weighted by export share



Sources: ABS; CEIC Data; Consensus Economics; RBA; Refinitiv.

The outlook for global economic activity is highly uncertain:

- *Inflation in advanced economies could prove to be more persistent than currently expected and could require further tightening of monetary policy*. This would ultimately lead to a sharper slowing in economic activity. This risk could materialise if recent increases in wages growth were to gain further momentum, particularly if inflation expectations were to rise or via indexation in price- or wage-setting processes. The effect of persistently stronger wages growth on inflation would be further amplified if labour productivity growth remains weak.
- *There is uncertainty about the effects of the cumulative monetary policy tightening to date and therefore the outlook for economic activity.*

- On the one hand, economic activity could continue to be surprisingly resilient, supported by initially strong private sector balance sheets or a slower-than-expected rise in unemployment rates (particularly if firms seek to hoard labour following a period where labour availability has been particularly tight). These factors could reduce or delay the effects of tighter monetary policy on activity relative to expectations. On the other hand, policy could have a larger effect than currently assumed. Central banks in advanced economies are forecasting that the current disinflation cycle will result in proportionately fewer employment losses than in previous disinflation episodes. While this partly reflects the unwinding of supply-induced inflation shocks – which causes less unemployment than demand-driven disinflation – there is still some risk that these forecasts are too optimistic and unemployment rises by more.
- *The recovery path for the Chinese economy is also uncertain*. Despite the recovery in Chinese household consumption so far, consumer confidence remains subdued and heightened economic uncertainty could lead to enduring incentives for households to build or maintain precautionary savings and reduce consumption. The outlook for the property sector also remains highly uncertain, with a recovery far from assured. Additional policy support for the property sector and household consumption could boost the recovery, but the scale and impact of any additional support measures are uncertain.

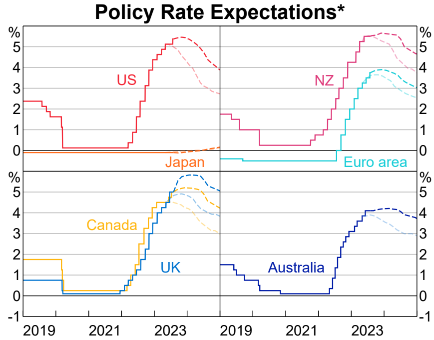
Central banks in advanced economies have raised policy rates further and market expectations have increased

Central banks in most advanced economies have increased policy rates further to reduce the risk that above-target inflation becomes embedded in price- and wage-setting behaviours. Market participants' expectations for the paths of policy rates have increased for most central banks over the past few months, with rates expected to stay higher for longer (Graph 1.24). These increases were driven by data that indicated inflationary pressures are more persistent than previously anticipated and statements from several central banks that additional policy tightening is likely to be required.

- The US Federal Reserve (Fed) increased the target range for its policy rate by 25 basis points to 5.25–5.5 per cent at its July meeting, after leaving rates unchanged in June. The Fed noted that while inflation had moderated, it remains well above its target and that decisions on whether additional policy rate increases are required would depend on incoming data.
- The European Central Bank (ECB) raised its key policy rate by a cumulative 75 basis points to 3.75 per cent at its May, June and July meetings. The ECB stated that it will continue to follow a data-dependent approach to determining the appropriate level and duration of policy restriction.

Graph 1.24

Policy Rate Expectations*



* Darker dashed lines show expectations implied by current overnight indexed swap rates; lighter dashed lines show the same expectations as at the May SMP.

Sources: Bloomberg; RBA.

- The Bank of Japan (BoJ) maintained its policy rate at –0.1 per cent but announced it would conduct its yield curve control policy with greater flexibility. While the BoJ will continue to use a reference range of ±0.5 per cent for 10-year Japanese Government Bond yields in determining its market operations, it has raised its strict cap on 10-year yields to 1 per cent.
- The Bank of England (BoE) raised its policy rate by 50 basis points to 5 per cent at its June meeting, above the 25 basis points expected by markets. The BoE noted the greater persistence in UK inflation in the context of a tight labour market and continued resilience in demand. This followed an increase in the BoE's policy rate by 25 basis points at its May meeting.
- The Bank of Canada (BoC) increased its policy rate by a cumulative 50 basis points to 5 per cent at its June and July meetings. Prior to its June meeting, the BoC had last raised its policy rate in late January. The BoC said recent increases reflected a concern that inflation could become stuck well above its target if monetary policy was not tightened further.
- Norges Bank raised its policy rate by 50 basis points to 3.75 per cent at its June meeting, above the 25 basis points expected by market participants. It said that it is likely to increase its policy rate again at its next meeting in August. It also raised its policy rate by 25 basis points at its May meeting.

Most central banks have continued to reduce their holdings of assets purchased under quantitative easing programs (Graph 1.25). In July, the ECB ended partial reinvestment of maturities under its Asset Purchase Program and began to allow all asset holdings under this program to mature without reinvestment. It will continue to reinvest maturing assets under its Pandemic Emergency Purchase Program until the end of 2024. In June, the Riksbank announced it would accelerate its sales of government bonds while continuing to allow its other assets to mature without reinvestment. The BoJ is the only major central bank that is still adding to its bond holdings. The reduction in central bank holdings of government securities is expected to improve functioning in markets where there is a shortage of privately traded government bonds (see Box A: The Bond–Overnight Index Swap Spread and Asset Scarcity in Government Bond Market).

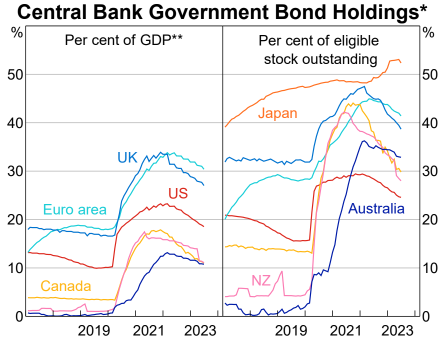
Central banks have continued to wind down term funding schemes established or expanded during the pandemic (Graph 1.26). A significant proportion of lending under the ECB's term funding scheme has now matured or been repaid, while most lending under the BoE and the Reserve Bank of New Zealand's (RBNZ) term funding schemes is not due to mature until 2024 or later.

Government bond yields have increased

Government bond yields have increased substantially over recent months, and most are near their highest levels in more than a decade (Graph 1.27). In most advanced economies, the increase in yields has been larger for short-term

Graph 1.25

Central Bank Government Bond Holdings*



* Central government debt only for all countries except the euro area. Holdings data for euro area only include bonds held as part of asset purchase programs; holdings data for the United Kingdom does not include purchases for financial stability purposes; holdings for other central banks also include bonds held for operational or liquidity purposes.

** Four quarter rolling sum. Japan (not shown) is currently 101% of GDP.

Sources: Central banks; debt management offices; RBA; Refinitiv.

bonds reflecting market expectations that central banks are close to having tightened policy enough and will, in time, be able to lower rates as inflation returns to target. Consistent with this, longer term real yields are also near their highest levels in more than a decade. Longer term market-implied inflation expectations remain between 2 and 3 per cent in most advanced economies (Graph 1.28).

Private sector financial conditions have been mixed

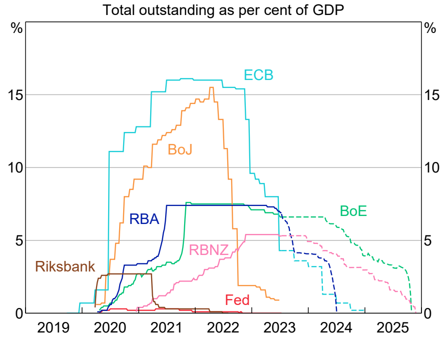
Yields on investment grade corporate bonds have increased in line with government bond yields in recent months (Graph 1.29). At the same time, yields on sub-investment grade bonds have declined as credit spreads have narrowed following the resolution of the US debt limit and an easing of concerns around US regional banking stresses. Corporate bond issuance picked up in May, particularly in the United States as companies bought forward issuance to avoid potential market disruption if there was to be a default on US Government debt. However, it has since returned to subdued levels seen earlier in the year. Bank bond issuance in the United States has remained subdued since the collapse of Silicon Valley Bank, while in Europe issuance has been steady.

Equity prices in the United States and Japan have increased over recent months but are little changed in Europe (Graph 1.30). Equity prices in

Graph 1.26

Term Funding Scheme Projections*

Total outstanding as per cent of GDP

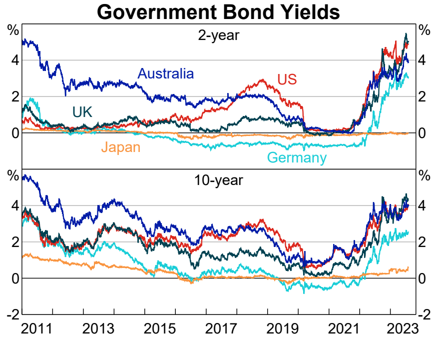


* Only includes schemes created in response to COVID-19 pandemic. Projected repayments and/or maturities are represented by dashed lines. Projections for the ECB are from the most recent ECB Survey of Monetary Analysts. Projections for the BoE, RBA and RBNZ are based on the assumption all outstanding funding is held until maturity.

Source: Central banks.

Graph 1.27

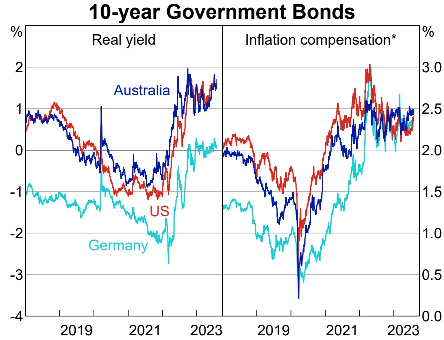
Government Bond Yields



Sources: Bloomberg; Yieldbroker.

Graph 1.28

10-year Government Bonds

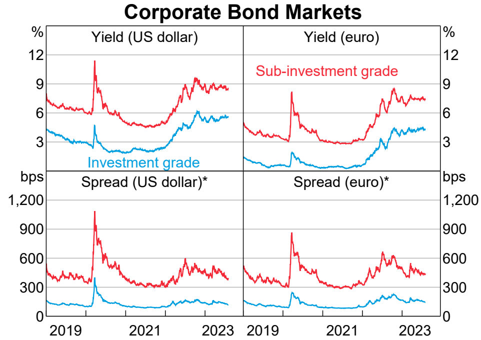


* Spread between yields on nominal and inflation-linked bonds.

Sources: Bloomberg; RBA; Yieldbroker.

Graph 1.29

Corporate Bond Markets



* Spread to equivalent maturity government bond yield.

Source: ICE Data is used with permission.

the United States have increased the most in the technology and consumer discretionary sectors, particularly in stocks perceived to benefit from developments in artificial intelligence. Equity markets also reacted positively to the resolution of the US debt limit. In Japan, the Topix reached a 33-year high, supported by a positive economic outlook, an expectation that monetary policy settings will remain accommodative and consistent foreign investor inflows.

Bank share prices in the United States, Europe and Japan have increased over recent months but remain around 10 per cent lower than their highs in 2023 in the United States and Europe. Better-than-expected second-quarter bank earnings results have contributed to increases in bank share prices in the United States. Regional bank share prices in the United States declined sharply following the collapse of First Republic Bank in early May and are still around 30 per cent lower than at the start of the year.

Credit growth in the United States and Europe has continued to slow in line with the earlier tightening in monetary policies. Meanwhile, deposit outflows from commercial banks in the United States have slowed significantly since the initial outflow of over US$400 billion following the emergence of stress at a number of US regional banks in early March. Aggregate bank deposits remain well below levels prior to the collapse of Silicon Valley Bank, particularly for smaller banks, and have been replaced with higher cost alternative sources of funding.

The US dollar is little changed

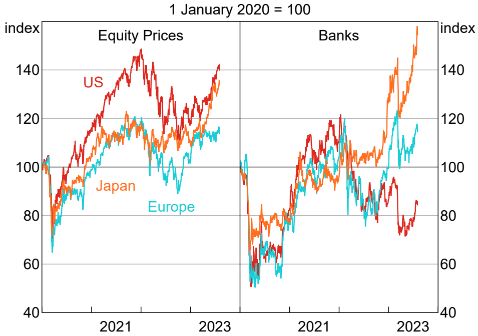
The US dollar is little changed on a TWI basis since the previous *Statement* but is almost 2 per cent lower since the beginning of the year. Although it depreciated in mid-July following lower-than-expected US inflation data, this has reversed of late (Graph 1.31). By contrast, the Japanese yen has depreciated further over recent months to be around 6 per cent lower on a TWI basis since the beginning of the year, reflecting the BoJ maintaining very accommodative monetary policy. Meanwhile, the euro is little changed over recent months.

The British pound has appreciated notably since the beginning of the year, supported by a large increase in UK Government bond yields relative to those of other advanced economies, which is consistent with higher policy rate expectations and inflation in the United Kingdom than elsewhere. Meanwhile, the currencies of commodity-exporting economies have been mixed. The Canadian dollar and Norwegian krone have appreciated on a TWI basis, while the New Zealand dollar and Australian dollar are

Graph 1.30

Equity Prices and Bank Indices

1 January 2020 = 100

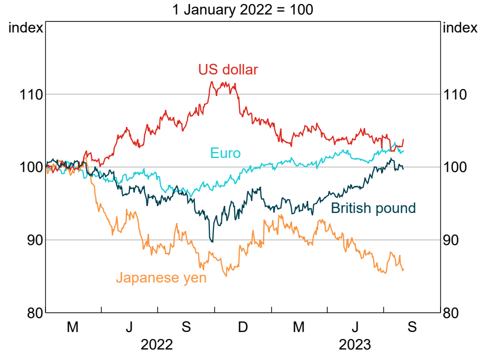


Source: Bloomberg.

Graph 1.31

Trade-weighted Exchange Rates

1 January 2022 = 100



Sources: Bloomberg; Board of Governors of the Federal Reserve System.

little changed (see Chapter 3: Domestic Financial Conditions).

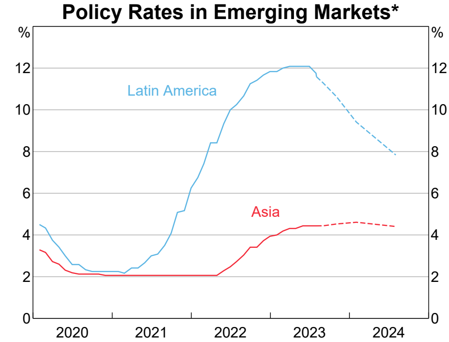
Financial conditions in emerging markets have generally been stable

Central bank policy rates in many emerging markets are expected by markets to have peaked. Some central banks in Latin America – which started raising policy rates earlier and by more than advanced economies – have begun to reduce policy rates as inflation has continued to ease (Graph 1.32). Consistent with this, spreads between US-dollar-denominated bonds and US Treasuries have also declined. In Asia, spreads have narrowed to multi-decade lows alongside inflation returning to central banks' targets quicker than in many advanced economies (Graph 1.33).

Exchange rates in Asia have been broadly stable while those in Latin America have continued to appreciate, supported by a positive interest rate differential with the United States. By contrast, the Argentinean peso has continued to depreciate amid very high inflation and despite a rise in the policy rate from 91 per cent to 97 per cent. The Turkish lira has also depreciated sharply alongside the appointment of new central bank governor and finance minister, who are widely expected to pursue more conventional economic policies, including less foreign exchange intervention.

Graph 1.32

Policy Rates in Emerging Markets*



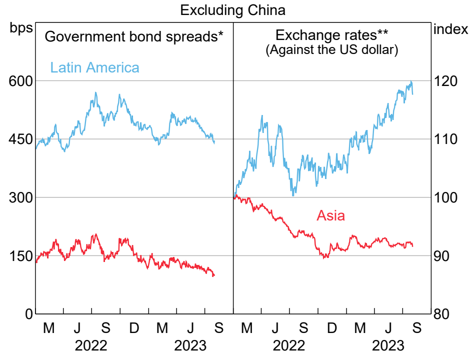
* Solid lines show actual policy rates; coloured dashed lines show market-implied policy rate expectations. Latin America is an average of Brazil, Chile and Mexico; Asia is an average of India, Malaysia, Philippines and Thailand.

Sources: Bloomberg; RBA; Refinitiv.

Graph 1.33

Emerging Markets – Financial Conditions

Excluding China



* US-dollar-denominated bonds; spreads to equivalent US Treasuries.

** 3 January 2022 = 100.

Sources: Bloomberg; JP Morgan; RBA.

Endnotes

[1] The major trading partner forecast downgrade also reflects a lower weight on the Chinese economy following an annual reweighting of Australia's export shares (Chinese GDP growth remains high relative to Australia's other trading partners despite the downward revisions to the forecasts).

Box A

The Bond–Overnight Index Swap Spread and Asset Scarcity in Government Bond Markets

Government bond yields are an indicator of overall financial conditions and provide a reference point against which many other interest rates are set. This can make them an important part of the monetary policy transmission mechanism in many economies, although to a lesser extent in Australia given the importance of the three-month bank bill swap rate to bank funding costs and lending rates. Typically, government bond yields reflect average expected policy interest rates over the term of the bond plus additional compensation for uncertainty about that path. The compensation that investors require for other risks, such as credit and liquidity risk, is typically low for advanced economy sovereign bonds given they are safe and liquid assets.

An overnight index swap (OIS) is a derivative contract where one party pays a fixed interest rate over the term of the contact (OIS rate) and receives a floating interest rate based on the (overnight) monetary policy rate, and the other party does the opposite. The fixed OIS rate reflects market expectations of the average policy rate over the term of the contract, and possibly also term and liquidity premia. As no principal is exchanged in an OIS, there is no compensation for credit risk embedded in OIS rates.

Since government bond yields and OIS rates are determined by similar factors, the spread between them is typically small and relatively stable. An exception to this is the period of positive spreads in Australia from around 2015, which may be associated with reduced demand to hold government bonds for liquidity purposes following the introduction of the Committed Liquidity Facility.[1] In 2020, the spread between bond yields and OIS rates returned to around zero alongside the sharp increase in Exchange Settlement balances and the Reserve Bank's unconventional policy measures.

The spread between government bond yields and OIS rates declined sharply in early 2022, at the same time as central banks in Australia and other advanced economies were raising policy rates rapidly (Graph A.1). While the current magnitude of the spread in most advanced economies is not unusual by historical standards, the fall in the spread means that changes in central banks' policy rates, and expectations for the policy rate, may not have fully passed through to other rates that use government bond yields as a benchmark. This could affect the strength of transmission to broader financial conditions in some economies.

This Box examines the factors that contributed to the spread between bond yields and OIS rates in a number of advanced economies, including Australia, over the past few years. In mid-to-late 2022, demand for short-dated government bonds increased amid heightened economic uncertainty and rising central bank policy rates. Investors substituted longer dated bonds and riskier assets for safe and liquid assets, which in turn put downwards pressure on short-dated government bond yields. In addition, this rise in demand for short-dated sovereign debt followed a period of central bank asset purchases that reduced the stock of government bonds available to the private sector (the so-called 'free float'). The combination of higher demand and a decline in the free float contributed to a 'scarcity premium' that put downward pressure on yields in some bond lines in a number of countries. More recently, the spread between bonds and OIS has narrowed in most economies.

Increased demand for safe and liquid assets put downward pressure on government bond yields

Demand for short-dated government bonds typically increases during periods of heightened policy rate uncertainty as investors look to increase holdings of safe and liquid assets and reduce interest rate risk. This puts downwards pressure on short-dated government bond yields relative to expected policy rates. This occurred in early 2022 when market uncertainty increased sharply as advanced economy central banks began raising policy rates rapidly and the outlook for the global economy became less certain. Russia's invasion of Ukraine in February 2022 and the UK mini-budget in September 2022 also contributed to higher bond price volatility, particularly in Europe.

The extra demand for safe assets in the face of such uncertainty is unlikely to extend to longer term bonds because investors tend to favour buying and holding shorter term securities to limit exposure to interest rate risk in an environment of rising interest rates. Long-term government bond prices are typically more volatile than short-term government bond prices; this is because, for a given change in yield, the price of a long-term bond moves more than for a short-term bond (Graph A.2).

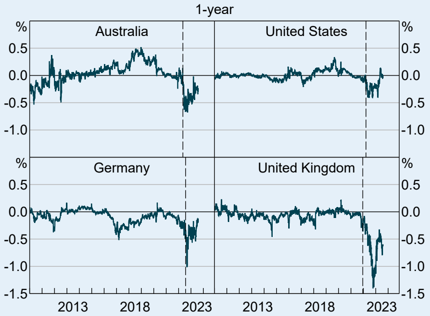
Meanwhile, central bank asset purchases reduced the supply of government bonds available to other market participants

During the COVID-19 pandemic, advanced economy central banks purchased significant quantities of government bonds, with net purchases continuing until either late 2021 or early 2022 in most economies. This activity reduced the stock of government bonds available to other market participants. In some cases, this contributed to a scarcity premium, as the scarcity of government bonds put additional downward pressure on

Graph A.1

Government Bond Yield Less OIS Rate*

1-year



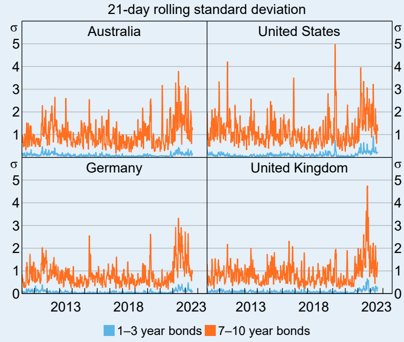
* Dashed lines correspond with first increase in policy rate.

Sources: Bloomberg; RBA.

Graph A.2

Government Bond Price Volatility

21-day rolling standard deviation



Source: ICE Data is used with permission.

the spread between bonds and OIS. The relatively larger free float in Australia – as well as the United States and Canada – compared with some European economies may help to explain why the spread between bonds and OIS did not decline as sharply in these countries (Graph A.3).

Central bank securities lending facilities can help to address the scarcity premium on particular bond lines by providing a backstop to access government bonds in high demand. Differences in the terms of these facilities appear to explain some of the variation in spreads between bonds and OIS across advanced economies. Demand for securities lending from the Reserve Bank has been concentrated on the bond lines with the lowest free float, and the Bank's lending of these bonds to the market has helped to reduce the scarcity premium and contribute to less-negative spreads between bonds and OIS. By contrast, more expensive borrowing costs and smaller limits on securities lending facilities are likely to have contributed to a more negative spread between bonds and OIS in some European economies.

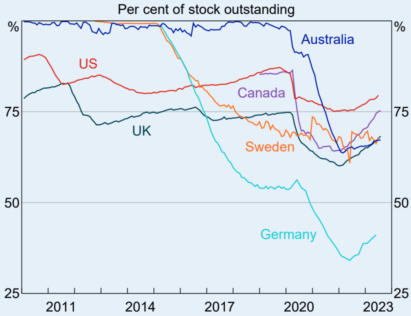
Spreads between government bond yields and OIS rates are likely to narrow in the period ahead

Some central banks and/or debt management authorities have taken steps to improve market functioning in a way that is likely to lead to a further narrowing in spreads between bonds and OIS back towards pre-pandemic levels. This includes providing targeted securities lending on scarce bond lines, such as the German Debt Management Office from October 2022, or pursuing active quantitative tightening and selling bonds, such as the Riksbank from early 2023. Moreover, volatility in government bond yields may decline as market expectations for policy rates stabilise and changes to policy rates become more modest. Finally, the free float of sovereign bonds will increase as quantitative tightening progresses (Graph A.4).[2] ✠

Graph A.3

Sovereign Bond Free Float*

Per cent of stock outstanding



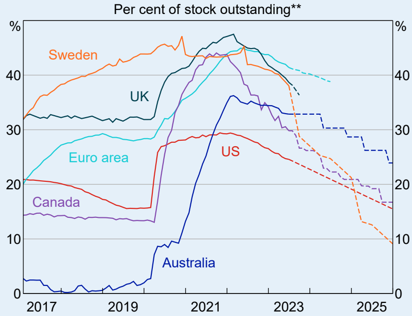
* Total outstanding issuance of central government marketable sovereign debt net of central bank holdings.

Sources: Central banks; debt management offices.

Graph A.4

Central Bank Government Bond Holdings*

Per cent of stock outstanding**



* Holdings include QE purchases as well as bonds held for operational or liquidity purposes except in euro area (QE purchases only) and the United Kingdom (excludes purchases for financial stability purposes). Projections represented by dashed lines.

** Projections use current outstanding stock.

Sources: Central banks; debt management offices; RBA; Refinitiv.

Endnotes

[1] The Committed Liquidity Facility was a commitment by the Bank to provide funds secured by high-quality collateral to certain authorised deposit-taking institutions in a period of liquidity stress. The Committed Liquidity Facility was introduced in 2015 to support Australia's implementation of the Basel III liquidity standard and ceased at the start of 2023 due to the improved availability of high-quality liquid assets to meet prudential liquidity requirements.

[2] As well as the projected reduction in outright central bank bond holdings, some sovereign bonds will re-enter the free float as collateral is returned from the unwinding of term funding schemes. However, sovereign bonds make up only a small proportion of the collateral pledged to these schemes, particularly in Australia.

2. Domestic Economic Conditions

The labour market remains tight, though the balance between labour supply and demand has improved since late 2022. Strong growth in the working-age population has continued to support employment gains over the first half of 2023. By contrast, economic activity was subdued as high inflation, higher interest rates and earlier declines in wealth weighed on growth. GDP growth has slowed considerably since mid-2022 and GDP per capita declined in the March quarter. Consumption growth was weak in recent quarters and timely indicators suggest it continued to be so in the June quarter. Headwinds to real household income growth remain, but the recent increase in housing prices has supported household wealth.

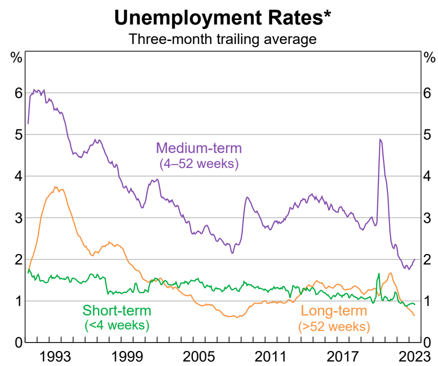
Measures of spare capacity in the labour market remain near multi-decade lows but have started to ease

The labour market was tight during the first half of 2023, though a broad range of measures suggest that the labour market is not as tight as it was in late 2022. The unemployment rate has been near its 50-year low of 3½ per cent since mid-2022 and is below 4 per cent in most states. The medium-term unemployment rate – a measure of cyclical unemployment that typically has the closest relationship with wages growth – has increased slightly in recent months but remains very low (Graph 2.1). The long-term unemployment rate has continued to decline to be around its lowest level in decades; much of the decline over recent years has been driven by long-term unemployed people finding jobs. More recently, there has been an increase in the share of long-term unemployed people leaving the labour force.

Broader measures of labour underutilisation have increased a little in recent months, consistent with the balance between labour demand and supply improving, but they remain near multi-decade lows (Graph 2.2). An increase in the underemployment rate (people with jobs but working fewer hours than they want) has driven most of the increase in these broader measures, though it likewise remains close to its lowest level in several decades.

Tight labour market conditions also manifest through higher job mobility (when a person changes jobs). Actual and expected job mobility have declined in recent months to levels observed immediately prior to the COVID-19 pandemic. Actual job mobility is around pre-pandemic levels in most industries but remains slightly elevated in healthcare. The share of

Graph 2.1



* Seasonally adjusted by the RBA.
Sources: ABS; RBA.

people leaving their jobs voluntarily has declined but remains above pre-pandemic levels; messages from firms in the Bank's liaison program suggest that the rate of job turnover has also declined relative to last year (Graph 2.3).

More people have a job than ever before

Employment growth remained robust in the June quarter, broadly keeping pace with strong growth in the working-age population and resulting in a record high employment-to-population ratio (Graph 2.4). More than one million people have found jobs since February 2020.

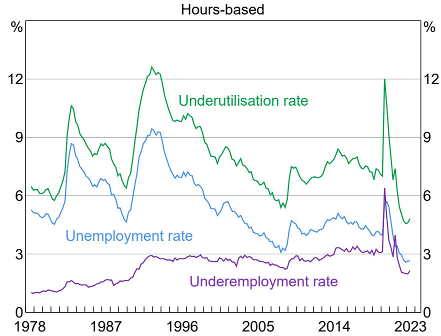
Strong labour demand has encouraged people to enter the workforce, with the participation rate remaining near its record high in recent months. Women and young people have driven the increase in participation since the start of 2020. Strong population growth has contributed to labour supply, as arrivals from overseas have increased to around pre-pandemic rates and fewer people than usual have departed the country (Graph 2.5).

People increasing their average hours worked and taking on second jobs have also played an important role in the adjustment of labour supply to strong demand over recent years. Full-time employment has accounted for all of the increase in employment since early 2020 (Graph 2.6). The share of employed people

Graph 2.2

Labour Underutilisation

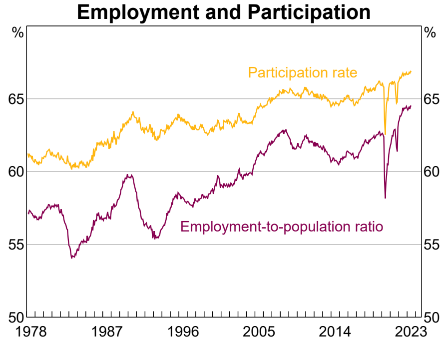
Hours-based



Sources: ABS; RBA.

Graph 2.4

Employment and Participation

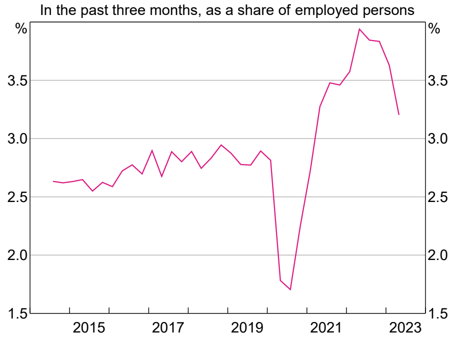


Source: ABS.

Graph 2.3

People Voluntarily Quitting Their Job*

In the past three months, as a share of employed persons



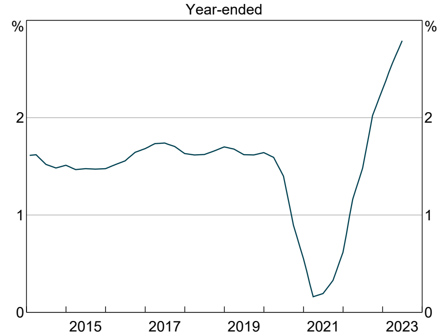
* Excluding retirements and 'other' reasons; seasonally adjusted.

Sources: ABS; RBA.

Graph 2.5

Working-age Population Growth*

Year-ended



* Population aged 15 years and over.

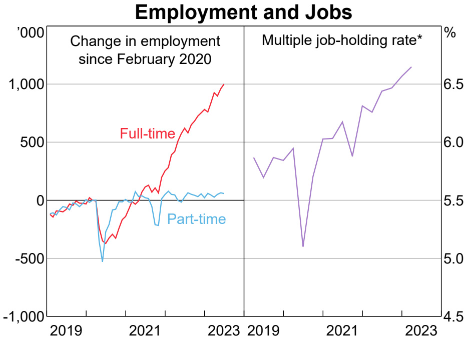
Source: ABS.

holding more than one job has increased to a record high of 6.6 per cent.

Measures of job advertisements and vacancies have moderated since mid-2022 but remain much higher than prior to the COVID-19 pandemic. There are still nearly as many vacancies as unemployed people, even as the number of vacancies has declined (Graph 2.7). Firms in the Bank's liaison program have reported an improvement in labour availability in some sectors, with some linking this to the arrival of foreign workers, though finding suitable labour continues to be difficult. Hiring intentions of firms in the Bank's liaison program have also eased since mid-2022.

Graph 2.6

Employment and Jobs

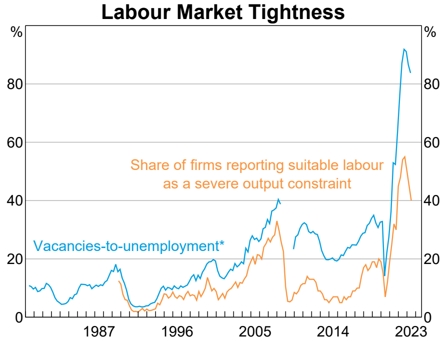


* As a share of employed persons.

Source: ABS.

Graph 2.7

Labour Market Tightness



* The ABS vacancies survey was suspended between May 2008 and November 2009.

Sources: ABS; NAB; RBA.

Domestic activity growth continued to moderate in the first half of 2023

Growth in the Australian economy has slowed significantly since mid-2022 (Graph 2.8). GDP growth in the March quarter was well below the pre-pandemic average as cost-of-living pressures, higher interest rates and earlier declines in wealth weighed on household incomes and consumption growth. The household saving ratio also declined to below its pre-pandemic decade average (Graph 2.9).

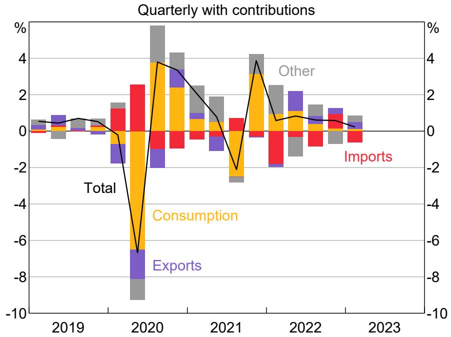
While consumption growth remained subdued and dwelling investment declined, growth in domestic demand in the quarter was resilient due to strong growth in business investment. The post-pandemic rebound in international students and tourists continued to boost net exports; this was more than offset by a bounce-back in goods imports as supply chain issues eased, particularly for passenger vehicles and telecommunications equipment. Timely indicators suggest domestic activity will remain subdued through mid-2023.

Population growth outpaced output growth in the March quarter and so GDP per capita declined (Graph 2.10). In nominal terms, the economy continued to grow strongly in the quarter, driven by growth in domestic prices and the terms of trade.

Graph 2.8

GDP Growth

Quarterly with contributions



Sources: ABS; RBA.

There have been several headwinds to household spending …

Real household disposable income in the March quarter was 4 per cent lower than a year ago (Graph 2.11). Real incomes have been weighed down by continued high inflation, strong growth in tax payments and higher net interest payments, as well as declines in small business incomes (led by decreases in the farm sector). These factors were partly offset by strong growth in labour income. Real household net wealth decreased by 8 per cent over the year to March, driven by lower housing prices.

While higher interest rates have weighed on aggregate household disposable income, the effects are being felt unevenly. Households that are net savers are receiving higher returns on their deposits, which is boosting their disposable income, while households that are net borrowers are facing higher interest payments (Graph 2.12). Aggregate interest receipts and payments will increase over the year ahead as the effect of earlier increases in the cash rate continue to be passed through to interest rates faced by households (see Chapter 3: Domestic Financial Conditions).

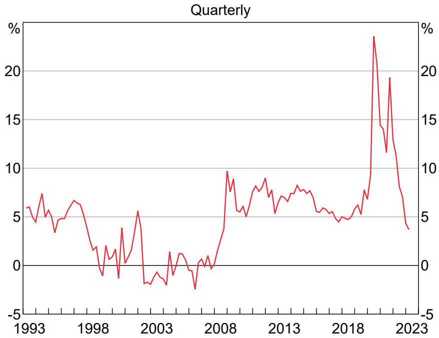
Growth in household consumption has been weak

Household consumption growth has slowed materially since mid-2022, with average growth of only ¼ per cent in recent quarters. This is well below the pre-pandemic average. The

Graph 2.9

Household Saving Ratio*

Quarterly



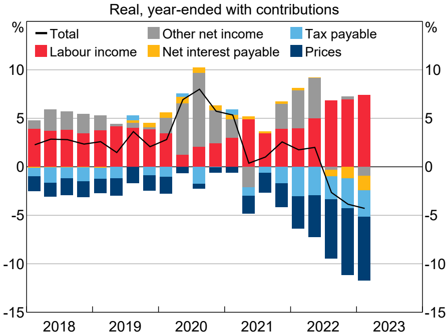
* Saving as a share of disposable income; net of depreciation.

Sources: ABS; RBA.

Graph 2.11

Household Disposable Income Growth

Real, year-ended with contributions

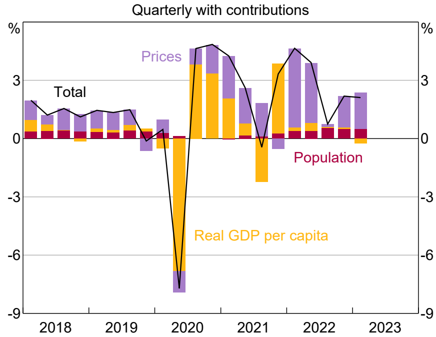


Sources: ABS; RBA.

Graph 2.10

Nominal GDP Growth

Quarterly with contributions

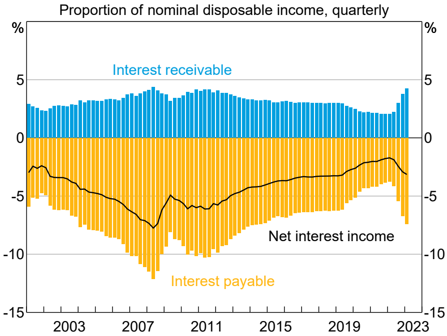


Sources: ABS; RBA.

Graph 2.12

Household Net Interest Income

Proportion of nominal disposable income, quarterly



Sources: ABS; RBA.

slowdown has been driven by weaker consumption growth for discretionary items (Graph 2.13). A range of timely indicators suggests that household consumption growth remained subdued in the June quarter. Retail sales values increased a little in the quarter but have been broadly unchanged since late last year; sales have been declining in real terms over this period (Graph 2.14). These outcomes are consistent with the weak conditions reported in liaison (see Box B: Insights from Liaison).

Sales of new cars have been relatively resilient to the softness in consumer spending. Cars are one of the categories of consumption most sensitive to changes in housing wealth; however, a large backlog of orders, as a result of earlier supply chain issues, has supported sales even as household wealth has declined. Car sales to households have remained strong in recent months, supported by orders that were placed several months earlier. Wait times for some models remain much longer than before the pandemic, although the ongoing easing in supply constraints could see more demand realised in sales in coming months.

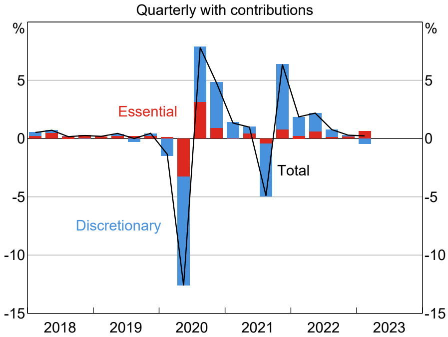
Despite slowing growth, household consumption per capita was close to its pre-pandemic trend level in the March quarter when excluding international travel (Graph 2.15). Nominal spending by Australian tourists overseas has picked up in recent months but remains around 20 per cent below pre-pandemic levels; real spending is even further below pre-pandemic levels because of strong price increases since 2019.

In contrast to the subdued growth in Australians' spending overseas, the recovery in international tourists and students coming to Australia continued to support economic activity (spending by tourists and students is treated as services exports rather than consumption in the national accounts). A large number of people entered the country to commence their studies in early 2023; the total number of international students in Australia is back to around pre-pandemic levels (Graph 2.16). Inbound tourism has also increased further in recent quarters but

Graph 2.13

Household Consumption Growth

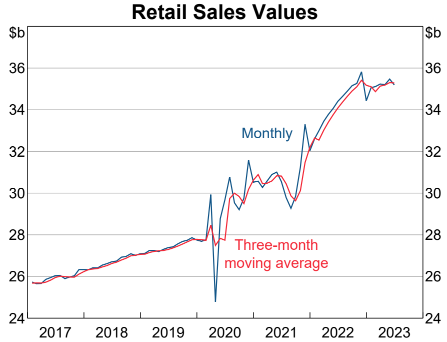
Quarterly with contributions



Sources: ABS; RBA.

Graph 2.14

Retail Sales Values

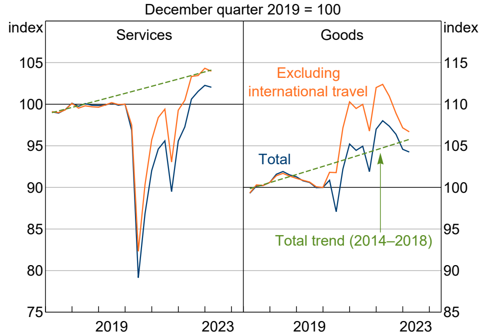


Sources: ABS; RBA.

Graph 2.15

Consumption Per Capita of Goods and Services

December quarter 2019 = 100



Sources: ABS; RBA.

Table 2.1: Growth in Housing Prices

Per cent, seasonally adjusted

	July	June	May	Since recent peak	Year-ended	Since Feb 2020
Sydney	1.3	1.5	1.3	–8	–2.3	16
Melbourne	0.6	0.8	0.6	–8	–4.1	3
Brisbane	1.5	1.1	0.9	–7	–6.4	31
Adelaide	1.3	0.9	0.6	0	0.9	46
Perth	1.1	1.0	1.0	0	3.2	29
Darwin	0.2	0.1	0.5	–2	–1.2	30
Canberra	–0.2	0.2	0.3	–9	–8.0	26
Hobart	0.2	–0.6	–0.2	–13	–11.5	19
Capital cities	1.1	1.2	1.0	–5	–2.8	16
Regional	0.5	0.5	0.3	–6	–5.7	33
National	1.0	1.0	0.9	–5	–3.5	20

Sources: CoreLogic; RBA.

remains below the levels seen prior to the pandemic, because of fewer tourists from China and constrained airline capacity.

The rebound in housing prices is supporting household wealth

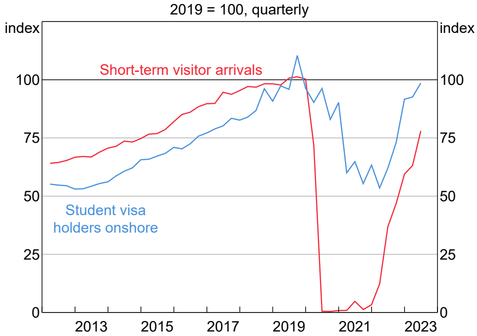
National housing prices have increased over recent months, following an 8 per cent decline from the April 2022 peak (Graph 2.17, Table 2.1). These increases have been broadly based across capital cities and most regional areas and have provided support to household wealth. The rebound in housing prices reflects a combination of stronger demand, partly due to the pick-up in population growth, and ongoing limited supply of new and established dwellings.

Other measures of housing market activity have been mixed in recent months. Housing turnover and residential listings are at low levels, although new listings have increased in some capital cities in recent months and auction clearance rates are higher than at the start of the year. Survey measures of housing price expectations have risen to be above their long-run average.

Graph 2.16

Inbound Travellers*

2019 = 100, quarterly



* Seasonally adjusted by the RBA.

Sources: ABS; Home Affairs; RBA.

The rental market remains very tight

Rental vacancy rates remain below their long-run average levels in Melbourne and Sydney and are around record lows in most other capital cities. Strong population growth has added to demand for rental properties, particularly in Sydney and Melbourne. Average household size has increased over recent months in capital cities, likely reflecting tight rental market conditions; this partially unwinds the decline in average household size observed since the onset of the COVID-19 pandemic (Graph 2.18). Average household size outside of capital cities has already returned to pre-pandemic levels.

Growth in advertised rents (for new leases) has been strong in capital cities, with advertised rents rising at their fastest pace in at least two decades in Sydney and Melbourne (Graph 2.19). By contrast, advertised rents growth has eased in most regional areas over the past year. Rents have grown more strongly for units than houses. Rental yields remained above pre-pandemic levels in all capital cities, though they have declined for Sydney and Brisbane in recent months as increases in housing prices have outpaced growth in rents.

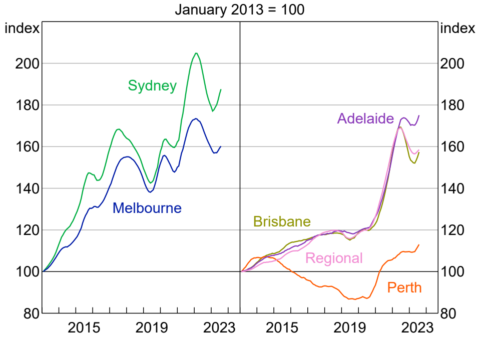
Capacity constraints continue to weigh on dwelling investment

Dwelling investment has declined by 5 per cent over the past year (Graph 2.20). While constraints on the supply of materials have eased, poor availability of tradespeople – particularly for the latter stages of construction – has continued to limit the pace of work done. These delays have contributed to the elevated pipeline of residential construction and, along with substantial increases in costs, have reduced cash flows for some firms and increased insolvencies in the industry over the past year. Construction insolvencies in the June quarter were at their highest level since the series began in 2013.

Graph 2.17

Housing Prices

January 2013 = 100

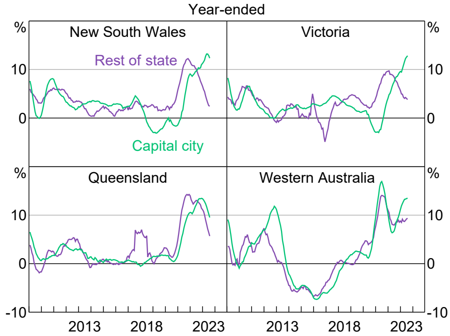


Sources: CoreLogic; RBA.

Graph 2.19

Advertised Rents Growth*

Year-ended

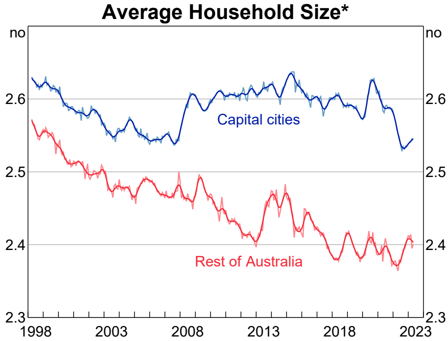


* Hedonic; seasonally adjusted.

Sources: CoreLogic; RBA.

Graph 2.18

Average Household Size*



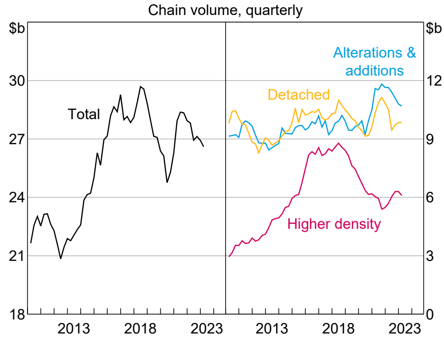
* Smoothed lines are 13-period Henderson trends.

Sources: ABS; RBA.

Graph 2.20

Private Dwelling Investment

Chain volume, quarterly



Sources: ABS; RBA.

Demand to purchase new detached dwellings has remained weak. Indicators such as building approvals, greenfield land sales and new home sales remained steady at low levels in the June quarter. Builders in the Bank's liaison program point to a range of factors weighing on demand, including higher interest rates, uncertainty around the cash rate path, higher construction costs and poor buyer sentiment due to construction delays and insolvencies. The recent weakness in demand for new detached dwellings is expected to weigh on dwelling investment once the backlog of dwelling construction is worked through (Graph 2.21).

Business investment remains strong but sentiment continues to ease

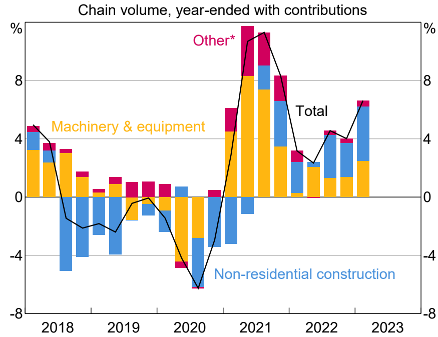
Business investment has increased strongly over the past year (Graph 2.22). Investment in machinery and equipment drove the pick-up in investment in the March quarter, reflecting strength in the agricultural, manufacturing, mining and transport sectors. Non-residential construction investment also increased, driven by expenditure on renewable and electricity projects in the eastern states.

Survey measures of investment intentions generally point to a positive short-term outlook for business investment, although the medium-term outlook has weakened. Measures of business conditions have softened further over recent months and business confidence is a little below its long-run average. The ABS Capital Expenditure Survey showed that, in aggregate, firms have revised down their expectations for investment in the 2023/24 financial year and nominal investment intentions are similar to 2022/23 (Graph 2.23). Information from the Bank's liaison program suggests that some firms anticipate delays to investment projects resulting from labour shortages, and some small firms are focusing on conserving cash rather than investing.

Graph 2.22

Private Business Investment Growth

Chain volume, year-ended with contributions

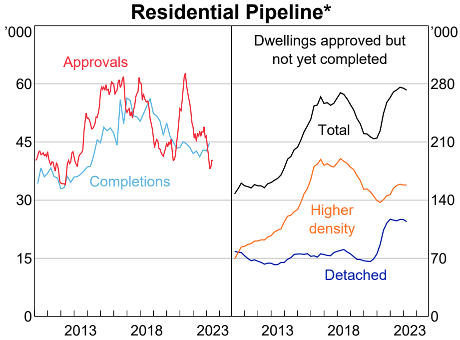


* Includes cultivated biological resources (mainly livestock, vineyards and orchards), computer software, research & development, mineral exploration and artistic originals.

Sources: ABS; RBA.

Graph 2.21

Residential Pipeline*



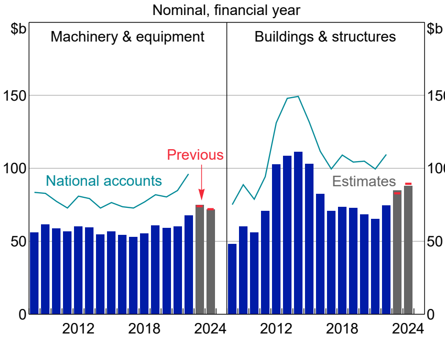
* Quarterly data except building approvals, which sum the three latest monthly observations.

Sources: ABS; RBA.

Graph 2.23

Capital Expenditure Intentions*

Nominal, financial year



* Estimates are firms' expected capital expenditure; adjusted for past average differences between expected and realised spending.

Sources: ABS; RBA.

Public demand growth has slowed

Public demand growth continued to slow in the March quarter as health expenditure associated with the COVID-19 pandemic continued to wind down (Graph 2.24). Public consumption as a share of nominal GDP remains at a high level compared with the pre-pandemic period, supported by public spending programs such as the National Disability Insurance Scheme and aged care. A large pipeline of infrastructure projects is expected to support public investment going forward.

The 2023/24 Australian Government Budget and various state budgets have reported an upgrade in the consolidated underlying cash balance in 2022/23 and smaller projected deficits over coming years (Graph 2.25). Higher commodity prices and a stronger-than-expected labour market have driven the improvement in budget positions.

Resources exports have been volatile in recent quarters

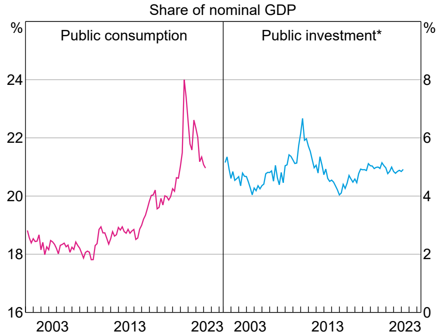
Net trade detracted slightly from GDP in March, as strong growth in goods imports more than offset growth in services exports (Graph 2.26). While rural exports rose following an exceptional year of growing conditions, this was offset by weakness in coal exports due to maintenance disruptions in the March quarter. Information from port authorities and trade data indicate that coal exports rebounded in the June quarter, with thermal coal exports to China returning to pre-pandemic levels.

Lithium export values have increased substantially in recent years to be Australia's fourth largest mineral export (behind coal, iron ore and gold) (Graph 2.27). The increase in lithium export values has been driven by higher prices on the back of increasing demand for

Graph 2.24

Components of Public Demand

Share of nominal GDP



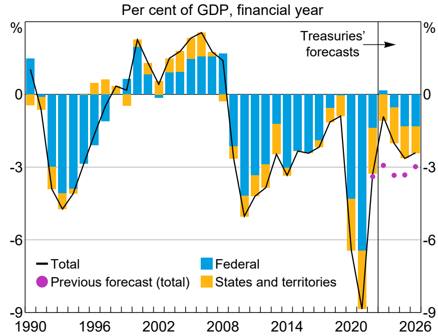
* Adjusted for second-hand asset transfers between public and other sectors.

Sources: ABS; RBA.

Graph 2.25

Consolidated Government Underlying Cash Balance

Per cent of GDP, financial year

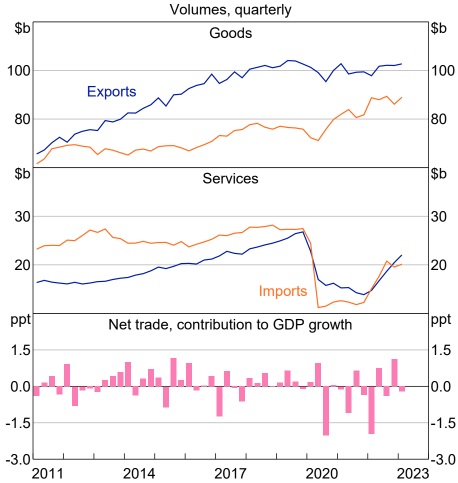


Sources: ABS; Australian Treasury; RBA; state and territory treasuries.

Graph 2.26

Trade in Goods and Services

Volumes, quarterly



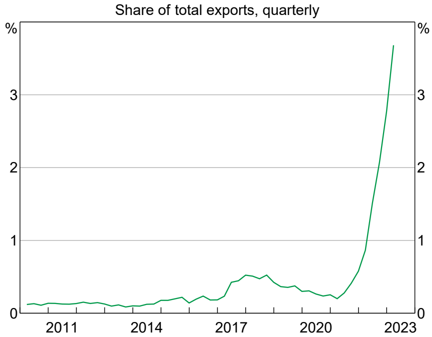
Sources: ABS; RBA.

batteries; export volumes have also increased as new mines have commenced production. ✠

Graph 2.27

Lithium Exports

Share of total exports, quarterly



Sources: ABS; RBA.

Box B

Insights from Liaison

This Box summarises information collected by five teams based in Adelaide, Brisbane, Melbourne, Perth and Sydney during discussions with around 230 businesses, industry bodies, government agencies and community organisations over the period from the beginning of May to early August 2023. Further information on the Reserve Bank's liaison program is provided in the September 2022 *Bulletin* article 'The Reserve Bank's Liaison Program Turns 21'.

The slowing in growth in private sector economic activity has been evident in information collected through the liaison program over recent months. Firms report that household consumption and demand for new residential construction have been subdued. Employment intentions have eased over the past six months, as has growth in most firms' costs and prices. Current and expected wages growth have been stable, though wage pressures remain higher than for many years. Contacts expect household spending and demand for residential investment to remain subdued over the next 12 months.

Household sector

Household consumer demand has softened

Sentiment of retailers in the Bank's liaison program has continued to deteriorate over recent months alongside declines in sales volumes. While most retailers have recorded modest declines in sales, a small number of household goods and clothing retailers have reported large falls in recent months. Firms report that low consumer confidence and cost-of-living pressures, including from higher interest rates, have led to more cautious spending. This has included households, particularly those on lower incomes, trading down to cheaper products and reducing basket sizes. Sales volumes at some retailers that target value-conscious shoppers have been relatively resilient, while other similar stores have reported large declines in their sales.

Spending on services has held up more than that for goods over recent quarters, though spending growth on some discretionary household services has slowed in recent months. Sales growth at hospitality venues has moderated slightly. Domestic tourism demand has declined, driven by reduced spending on leisure travel. The decline in tourism demand has been larger in some regional areas than capital cities, partly reflecting households substituting back towards overseas travel. Spending on discretionary services, such as major events, remains elevated. In the higher education sector, growth in domestic student numbers has been weak; contacts attribute this to the tight labour market, with many potential students choosing to work rather than pursue university study, and to pent-up demand for travel and gap years.

Firms expect household spending to decline further over coming months. Most retailers expect sales volumes to remain subdued, particularly for non-essential items. Domestic tourism contacts generally expect demand to weaken further in response to higher interest rates and other cost-of-living pressures. Universities see the outlook for the higher education sector as highly uncertain, and dependent on how the job market evolves over the next 12 months.

Community services organisations are providing more assistance

In discussions with the Bank, community services organisations have continued to emphasise an increase in calls for their services over the past six months, including for housing assistance, financial counselling services, mental health services, domestic violence services and food support. They attribute this largely to increases in basic living costs – for example, on housing, energy and food – which constitute a larger share of spending for people on lower incomes. Contacts have said that the shortage of affordable housing and the higher cost of living are causing an increase in homelessness. People with jobs are now also seeking food support assistance more often than in the recent past and higher interest rates have contributed to an increase in demand for services from people with a mortgage. Community organisations report ongoing difficulties in their operating environment due to staffing challenges, reflecting the tight labour market, higher costs and concerns about funding levels.

Business sector

Residential construction activity is expected to decline

Challenges in the delivery of new housing have persisted over recent months. Shortages of trade labour continue particularly around the latter stages of construction, such as for tilers and painters. The elevated number of construction firm insolvencies is also contributing to delays because alternative arrangements need to be made for project completions. These delays mean some residential construction firms still have a backlog of work to be completed, which may push out the decline in aggregate residential investment. Completion times improved modestly over the quarter, and a return to more normal build times is anticipated in 2024.

Firms expect that residential construction activity will start to decline from the latter part of this year due to very low sales of new homes over recent quarters feeding through to a lower level of work to be done. A scaling back of projects in some cases is also expected to contribute to this decline. Leading indicators of activity appear to have stabilised at low levels, partly supported by a modest increase in new detached home sales and increased investor demand in Western Australia and Queensland. Over the medium term, a number of contacts are more optimistic, supported by strong population growth. However, the current lack of a supply response amid strong underlying demand from the increase in population is expected to lead to ongoing tightness in rental markets for the period ahead.

Financial conditions among construction firms continue to be tighter than firms report in most other industries. Finance is less readily available, and the cost of funds has risen in line with higher interest rates. Some contacts are concerned that a high number of insolvencies in the industry will persist over the period ahead and further dampen confidence in the sector.

Business investment intentions have softened recently

Many contacts continue to report that their investment levels have been elevated over recent quarters and that further investment is planned in the near term. Liaison suggests that resources investment will increase a little over coming years, driven by bulk commodity projects and supported by investment in battery minerals. The level of non-mining investment is being supported by a broad range of projects across renewable energy, transport, storage and infrastructure construction. Many firms also have digitisation and automation projects underway or planned.

Most firms report that finance remains readily available, though the cost of debt has increased in line with cash rate rises. That said, some smaller businesses are reducing their investment intentions because of higher interest payments and deteriorating business conditions. Further, over recent months firms have generally reported that a range of factors, including a slowing economy, have led to an easing in their investment plans for the next 12 months (Graph B.1).

Firms also report a number of risks to the timely delivery of their investment plans. Securing labour is still a challenge for construction and engineering projects and related delays are common. Major electricity transmission projects, and associated renewable energy generation projects, are at risk of being pushed out because of difficulties in securing land access. Commencement of some new office projects have been delayed because vacancy rates are elevated in many major cities and office values have declined. Firms have also noted that lower valuations for offices are expected, which may weigh on financing and new project commencements.

Exports are expected to grow over the period ahead

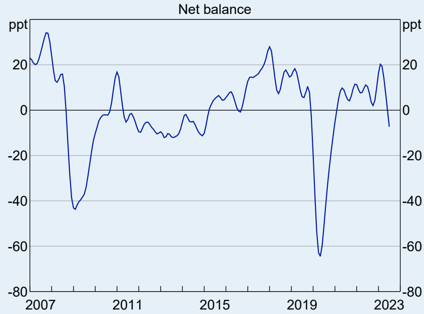
Services exports have recovered further. International student commencements increased in the first half of the year and have reached their pre-pandemic levels at several universities. Demand from students from South Asia has been a strong driver of the recovery, and universities expect student commencements to grow further in the second half of 2023. However, contacts have flagged that the tight rental market may constrain increases in student numbers going forward, particularly in Brisbane and Sydney.

Sales at international tourism operators have grown over recent months as overseas visitors have returned; however, sales

Graph B.1

Non-mining Investment Intentions*

Net balance



* Over the next 12 months; 13-month Henderson trend; rescaled to have zero mean.

Source: RBA.

generally remain below pre-pandemic levels. International flight capacity is still regarded as a constraint on a full recovery of overseas visitors and the recovery in Chinese tourist numbers continues to be slower than the broader recovery in inbound tourism demand.

Commodity exports are generally expected to rise. In addition to an expected modest increase in bulk commodity exports, investments in productive capacity for battery-related minerals will boost exports of non-bulk mining commodities in the period ahead. On the agricultural side, contacts expect livestock supply and, in turn, exports to increase a little further over coming years. By contrast, non-livestock rural exports are expected to decline over the next 12 months, from very high levels, as drier weather conditions lead to lower crop production.

Hiring intentions are little changed, and labour availability has improved

Hiring intentions for most liaison contacts have remained broadly steady over the past few months (Graph B.2). Most firms are still looking to either increase or maintain headcount over the year ahead, and labour demand for household services firms remains resilient. Intentions have weakened for firms exposed to the residential construction sector, consistent with expectations for a decline in construction activity. A number of firms in the wholesale and retail sector have also reported lower hiring intentions; some have already reduced employee hours over recent months in response to declining demand and an increased focus on cost control.

Hiring new labour has become a little easier for most firms in recent months, and staff turnover rates have generally declined. However, both labour availability and turnover remain more challenging for firms than prior to the pandemic, and some continue to report little improvement in conditions. For those firms reporting an improvement in hiring conditions, several linked this to an increasing availability of both skilled and unskilled foreign workers, consistent with the increase in migrants.

Costs and prices

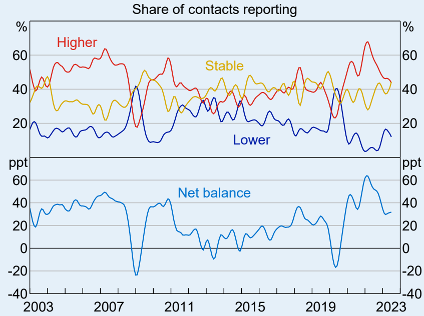
Private sector wages growth is still tracking around 4 per cent

Firms reported that year-ended growth in private sector wages was around 4 per cent in the June quarter, similar to the March and December quarters. Around 60 per cent of firms reported wages growth of between 3 per cent and 5 per cent, and one-quarter of firms reported wages growth above 5 per cent (down from around one-third of firms in late 2022) (Graph B.3). Overall, reported wages growth over recent months remains above pre-pandemic growth rates in all industries; the range of observations across firms is broadly similar to that seen in the mid-2000s.

Graph B.2

Employment Intentions*

Share of contacts reporting



* Over the year ahead; smoothed with a 13-month Henderson trend.

Source: RBA.

For the past 12 months, firms' expectations for year-ahead wages growth have been steady at around 4 per cent. Wages growth is expected to moderate somewhat over coming quarters for workers covered by individual agreements, but to be similar or a little stronger for other workers. This year's Fair Work Commission decision for award wages was higher than some firms anticipated, but few expect it to have a larger spillover effect on wage bargaining outcomes than in prior years. Around one-quarter of firms expect wages growth to slow over the year ahead, with these firms noting drivers such as lower staff turnover, less competition for labour, slowing business conditions and cost control.

The pace of overall input cost increases continues to ease

Many firms have reported a further slowing in the pace of input cost increases over the past few months. The cost of imported goods is declining as availability of products improves. International freight rates have declined to be closer to pre-pandemic levels (and in some cases are lower), alongside slowing global demand and increased freight capacity. However, cost increases from domestic inputs have remained high – particularly energy, labour (discussed above), transport and insurance – and these increases are partially offsetting the lower costs of imported goods.

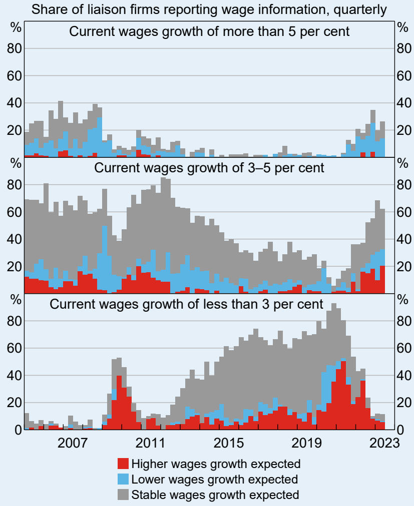
Firms on the east coast are still reporting large increases in energy costs where prices are variable or contracts have been renewed. Some contacts have been less exposed to rising energy prices because of pre-existing long-term contracts or because they have rooftop solar power. Several firms expect energy costs to increase further in the period ahead as contracts are renewed. The price of default electricity offers for small businesses on the east coast increased by around 15–30 per cent on 1 July 2023 (and by 21–25 per cent for households).

Overall, firms still expect growth in their aggregate costs to ease further over coming months but note ongoing domestic cost pressures.

Graph B.3

Current Wages Growth and Expectations

Share of liaison firms reporting wage information, quarterly



Source: RBA.

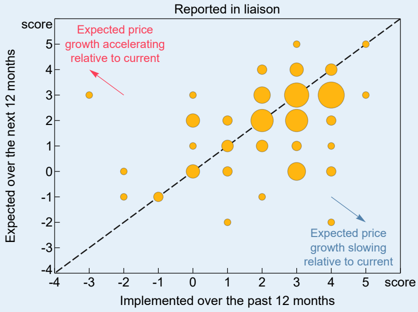
Price pressures persist, but firms are increasingly cautious about raising prices

More firms expect price growth to slow, rather than accelerate, over the next 12 months (Graph B.4). Firms have noted in recent months that ongoing labour cost increases are placing upward pressure on prices. Most goods-related firms intend to increase prices in response to costs growth, but typically expect these to be smaller than over the past 12 months. This reflects the overall easing in the rate of cost increases as well as firms being cautious about the detrimental effects that large price rises might have on demand. Some retailers have been discounting in response to a decline in demand or to clear excess inventory, while others have noted rising competition – both of these factors are expected to weigh on price increases over the next 12 months.

Graph B.4

Firms' Price Changes*

Reported in liaison



* Compares quantitative scores assigned by staff based on the extent of change in the key economic variables firms expressed in meetings over the past three months; dot size is proportional to the number of firms recording that combination of current and expected price outcomes.

Source: RBA.

3. Domestic Financial Conditions

Australian financial conditions have tightened further since the previous *Statement*. The Reserve Bank has increased the cash rate target by 25 basis points to 4.1 per cent and market pricing suggests that the cash rate may be increased once more by the end of the year. In response to these changes, money market rates and yields on Australian Government Securities (AGS) have increased alongside higher cash rate expectations and higher government bond yields globally.

Banks' funding costs have increased in response to increases in the cash rate and bank bill swap (BBSW) rates. Banks have increased both lending and deposit rates, although both have risen by less than the cash rate over the tightening phase. Scheduled mortgage repayments have increased further in recent months and will continue to rise as more fixed-rate loans roll off onto higher interest rates. At the same time, extra payments into offset and redraw accounts have declined as higher interest rates and cost-of-living increases put pressure on household budgets. Housing credit growth has stabilised, supported by a modest increase in housing loan commitments alongside a rise in housing prices; business credit growth has also levelled out of late.

The Australian dollar is little changed on a trade-weighted (TWI) basis since May. The yield differential between AGS and government securities of the major advanced economies has eased of late to be around its levels a few months ago. Meanwhile, concerns about the outlook for the Chinese economy have weighed on the Australian dollar and the prices of Australia's key commodity exports remain lower than earlier in the year.

The cash rate has increased

Market participants' expectations for the path of the cash rate, as implied by overnight index swaps (OIS), have increased since the previous *Statement* (Graph 3.1). At that time, it was expected that the prevailing cash rate of 3.85 per cent would be close to the peak in this tightening phase, in part reflecting lingering risks of banking stress in some countries overseas. Since then, the Reserve Bank has increased the cash rate target by 25 basis points to 4.1 per cent, and market pricing implies that the cash rate may be increased once more by the end of the year; this stands in contrast to market pricing in May, which had implied an expectation of reductions in the cash rate in the latter part of 2023. The median forecast of market economists is for a similar peak in the cash rate to that implied by market pricing.

Transaction volumes in the cash market have continued to increase, and the cash rate has been determined by market transactions almost every day since late March. The cash rate has remained 3 basis points below the cash rate target.

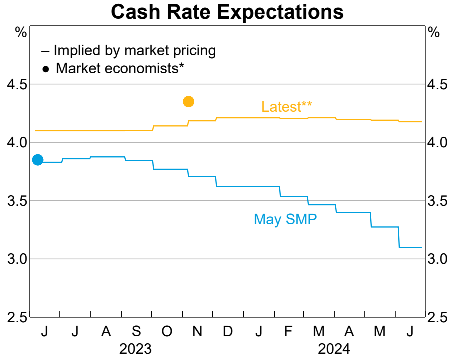
Money market rates have continued to rise

BBSW rates, which are a key influence on banks' funding costs, have risen by more than cash rate expectations over the past three months (Graph 3.2). This rise has been more pronounced at the six-month tenor, driven – at least in part – by upcoming Term Funding Facility (TFF) maturities in August and September, with banks increasing issuance of longer dated bank bills to cover this period. The cost of sourcing Australian dollar funding offshore (by issuing short-term US dollar securities and swapping the proceeds in the foreign exchange market) also increased for a time in this period.

Repurchase agreement (repo) rates at the Bank's regular open market liquidity operations (OMO) have increased in line with OIS rates, with the OMO hurdle rate continuing to be set at term-matched OIS plus a modest spread. Demand for short-term Australian dollar liquidity obtained at OMO remains modest.

Graph 3.1

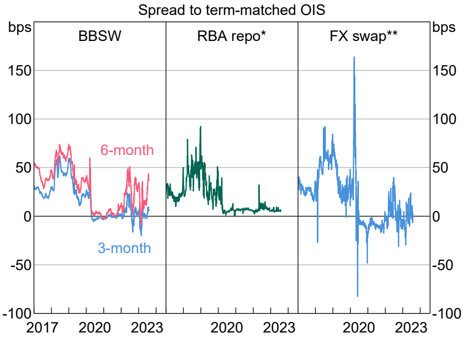
Cash Rate Expectations



* Median peak rate called by market economists.
** Latest projections as at 3 August 2023.
Sources: Bloomberg; RBA.

Graph 3.2

Australian Dollar Money Market
Spread to term-matched OIS



* Weighted average rate for morning open market operation repos.
** Implied AUD rate based on covered interest parity.
Sources: ASX; Bloomberg; RBA; Tullet Prebon; US Federal Reserve.

AGS yields have risen

Over recent months, yields on AGS rose to their highest levels in around a decade (Graph 3.3). This was alongside an abatement of stresses in some overseas banking systems and increases in market participants' policy rate expectations amid persistent inflation. The rise in yields was most pronounced for short-term securities; in June, the yield on three-year AGS rose above that on 10-year AGS for the first time since 2008. More recently, AGS yields have fallen from their peaks alongside lower inflation outcomes in Australia and some other countries and as expectations for further policy tightening have lessened.

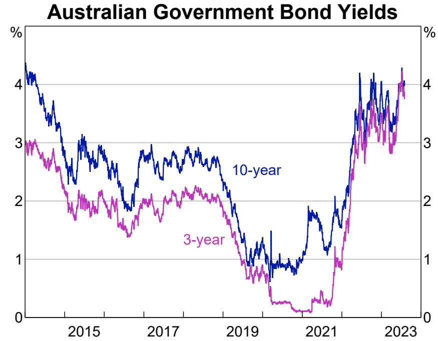
The increase in AGS yields has been underpinned by a rise in real yields, while break-even inflation rates have remained relatively stable and well anchored (Graph 3.4). This implies that market participants expect the Reserve Bank to keep inflation within the target range over the medium term.

Yields on 10-year AGS are around those on US Treasuries, while three-year AGS yields remain below US Treasury yields (Graph 3.5).

Yields on semi-government securities (semis) have increased by less than AGS yields, with the

Graph 3.3

Australian Government Bond Yields



Sources: Bloomberg; RBA.

spread to AGS yields around their narrowest levels in about a year (Graph 3.6). Strong issuance of semis has been met with strong demand – including from domestic banks to hold semis as part of their portfolios of high-quality liquid assets (HQLA).

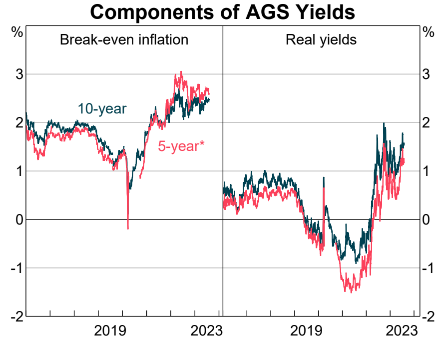
Bond markets are functioning well

Bid-offer spreads on AGS and semis are very low, and demand from both domestic and international investors remains strong. The volatility of yields has declined in recent months to be around its historical average as concerns around offshore banking stresses have abated (Graph 3.7). Demand to borrow AGS from the Bank has continued to decline in recent months, with an average of around $2 billion of bonds borrowed per day since the previous *Statement*.

Issuance of AGS over the year to date by the Australian Office of Financial Management (AOFM) has been well below that of recent years (Graph 3.8). In June, the AOFM stated that issuance in the 2023/24 fiscal year will be lower than the $75 billion plan announced in the Budget, reflecting a larger government surplus in the 2022/23 fiscal year than had been forecast. Semis issuance has remained strong in 2023, with issuance to date higher than observed in recent years.

Graph 3.4

Components of AGS Yields

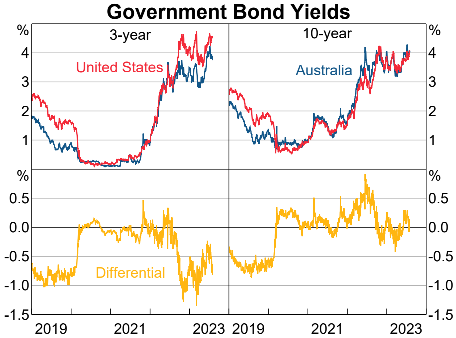


* 5-year breakeven inflation unavailable from April 2020 to September 2020 due to data quality issues.

Sources: Bloomberg; RBA.

Graph 3.5

Government Bond Yields

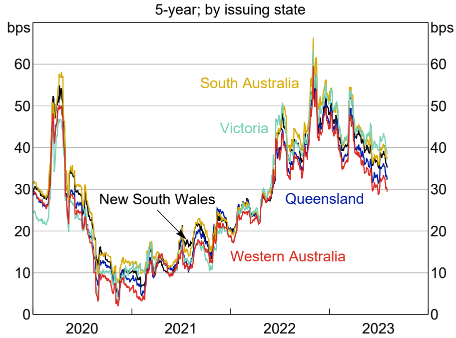


Sources: Bloomberg; RBA.

Graph 3.6

Semi-government Bond Spreads to AGS

5-year; by issuing state

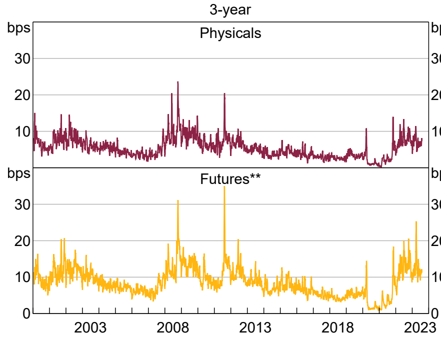


Sources: Bloomberg; RBA.

Graph 3.7

Bonds Intraday Range*

3-year



* Ten-day moving average.

** Includes overnight session.

Sources: Bloomberg; RBA.

The Bank's balance sheet has decreased and is set to decline further

The Bank's balance sheet has decreased by $25 billion to around $590 billion since the previous *Statement*. The decrease was driven by TFF loan maturities and a reduction in the market value of the Bank's bond holdings, owing to a rise in bond yields over the past few months (Graph 3.9). This fall in assets was matched on the liabilities side by a fall in commercial banks' Exchange Settlement (ES) balances, as maturing TFF loans were repaid (Graph 3.10). The Bank's balance sheet will decline noticeably over the next few years as bond purchases and TFF funding provided to banks mature.

The Term Funding Facility has begun to unwind

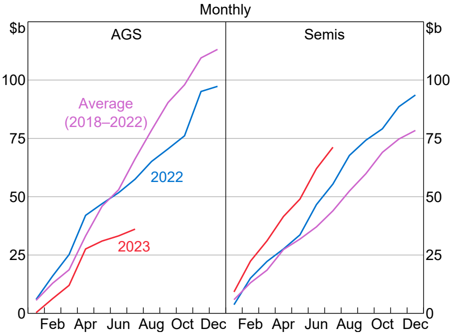
A total of $188 billion of funding was provided under the TFF, of which $25 billion had matured by the end of July, with a further $53 billion to mature in August and September. This represents the first of two concentrated maturity periods, with $93 billion to mature in the June 2024 quarter (Graph 3.11).

Banks use their ES balances to repay the TFF. These ES balances qualify as HQLA for the purpose of banks' regulatory liquidity ratios. However, most of the collateral that have secured banks' TFF loans are self-securitised

Graph 3.8

Cumulative Gross Issuance

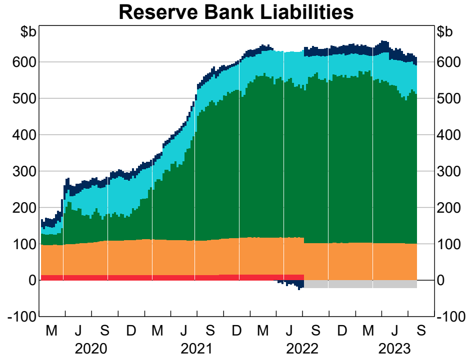
Monthly



Sources: AOFM; Bloomberg; RBA.

Graph 3.10

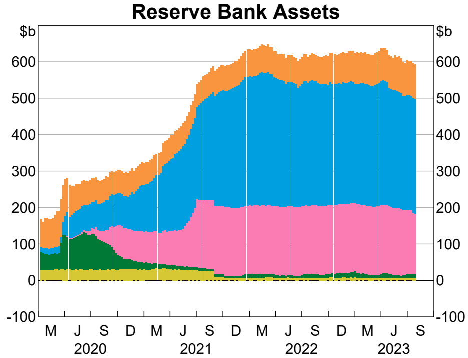
Reserve Bank Liabilities



Source: RBA.

Graph 3.9

Reserve Bank Assets

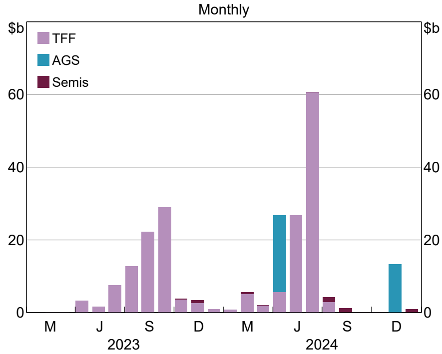


Source: RBA.

Graph 3.11

TFF and Government Bond Maturities*

Monthly



* Face value of outright holdings.

Source: RBA.

assets, which do not qualify as HQLA. Banks can source replacement HQLA if they choose to offset the impact of TFF maturities on their liquidity ratios, which are currently well above regulatory requirements. Indeed, bank bond issuance has been above average over 2023 to date, with some of this funding being used to purchase HQLA securities. Even so, TFF loan maturities are not expected to increase bank funding costs materially. This is because TFF loans accounted for only around 5 per cent of banks' funding when it was provided and banks have hedged much of this borrowing (and hence funding costs) back to floating rates, which have already increased alongside the cash rate.

Bank bond issuance is above average in gross and net terms

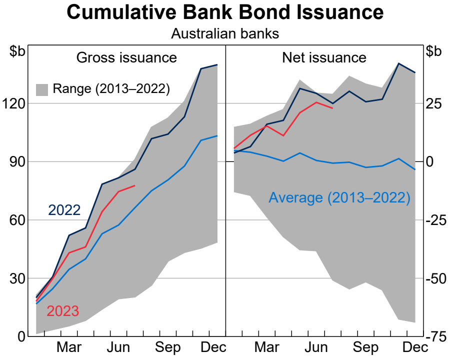
Bank bond issuance has slowed over recent months but remains above average over 2023 to date following strong issuance earlier in the year (Graph 3.12). Banks raised $32 billion via bond issuance over the past three months, evenly split between domestic and offshore markets. Covered bond issuance was particularly strong, increasing to $11 billion, with over two-thirds of this offshore; this strength may, in part, reflect increased investor preference for secured products given uncertainty about the economic outlook.

Yields on three-year banks bonds have increased over recent months alongside higher swap rates and AGS yields, to be over 5 per cent (Graph 3.13). The spread to the swap rate for bonds issued by the major banks has declined slightly but remains around the range seen in the years prior to the pandemic. Banks generally swap fixed-rate payments on newly issued bonds into floating-rate payments to match their floating-rate loan assets, and so the spread to swap is an important component of bank funding costs.

Issuance of asset-backed securities has been high over recent months

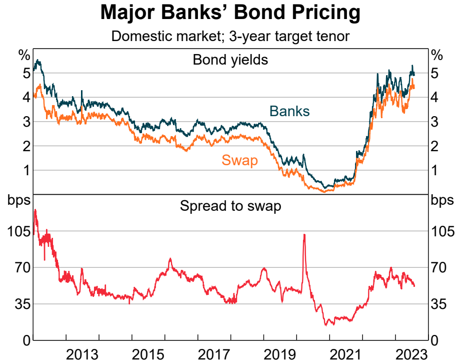
Issuance of asset-backed securities (ABS) was around $12 billion over the past three months (Graph 3.14). Residential mortgage-backed securities (RMBS) accounted for over two-thirds of this. Issuance continued to be driven primarily by non-bank lenders, which use the securitisation market as their key source of funding. Issuance of other ABS increased to $3 billion, driven by issuance of securities backed by auto and equipment assets. Strong issuance of 'other ABS' over the year to date partly reflects non-bank lenders shifting their lending from housing mortgages, where they have become less competitive compared with banks, towards other types of loans. RMBS

Graph 3.12



Sources: Bloomberg; Private Placement Monitor; RBA.

Graph 3.13



Sources: Bloomberg; RBA.

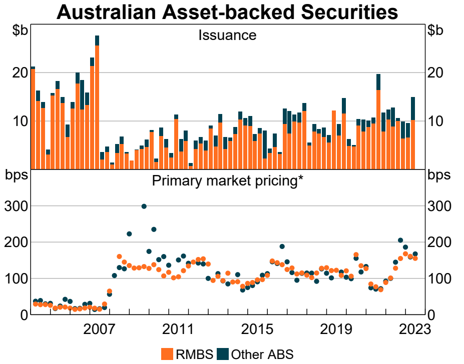
spreads have declined slightly in recent months, while spreads on other ABS remain at the wider end of their pre-pandemic range.

Deposit growth has slowed

The total stock of deposits has grown more slowly over the past six months than during the pandemic, in part because slowing credit growth creates fewer new deposits (Graph 3.15). Depositors have continued to shift from at-call deposits to term deposits, which typically offer significantly higher returns (see below).

Graph 3.14

Australian Asset-backed Securities

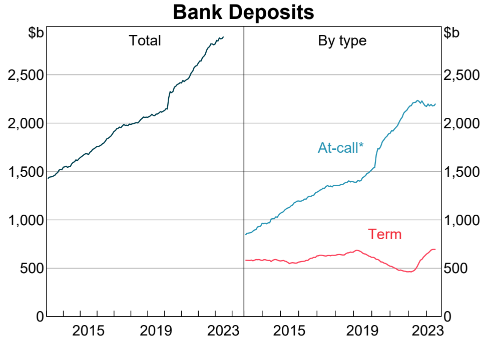


* Face-value weighted quarterly average of the primary market spread to bank bill swap rate for AAA rated notes.

Sources: Bloomberg; KangaNews; RBA.

Graph 3.15

Bank Deposits



* Includes deposits in housing loan offset accounts and non-interest bearing deposits.

Sources: APRA; RBA.

Bank funding costs have increased further

Banks' overall funding costs rose in the June quarter, underpinned by higher BBSW rates (Graph 3.16). Much of banks' wholesale debt and deposit costs are linked to BBSW rates either directly or through banks' hedging activities. This includes banks swapping foreign-currency denominated and fixed-rate liabilities for floating-rate exposures that reference BBSW.

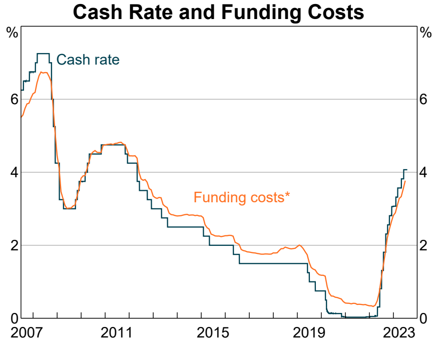
Deposit rates have risen more on some products than others

The average rate on outstanding at-call deposits – comprising around three-quarters of total deposits – has risen by 240 basis points since May 2022, which is 160 basis points less than the increase in the cash rate (Graph 3.17). This includes around 10 per cent of at-call balances on which banks pay no interest (although banks often hedge such deposits to mitigate volatility in earnings so their effective cost to banks increases with BBSW rates). Banks have increased advertised rates on 'bonus savers' (where depositors must meet certain conditions to receive a higher interest rate) more than on standard at-call savings accounts.

The average rates on new term deposits have increased by more than the cash rate since the

Graph 3.16

Cash Rate and Funding Costs



* RBA estimates of overall outstanding hedged debt and deposit costs for the major banks.

Sources: ABS; AFMA; APRA; ASX; Bloomberg; major bank liaison; major banks' websites; RBA; Refinitiv; Securitisation System; Tullett Prebon; US Federal Reserve; Yieldbroker.

start of the cash rate tightening phase, in line with larger movements in BBSW and swap rates, which are the key benchmarks used to price these products. Rising term deposit rates also partly reflect banks' interest in growing term deposits given their favourable treatment in liquidity ratios (compared with at-call deposits) as they prepare for TFF maturities.

In February, the Treasurer directed the Australian Competition and Consumer Commission to conduct an inquiry into the market for retail deposits, including on the interest rates paid on deposits and the nature and extent of competition in the supply of this product.[1] The final report is due in December this year.

Lending rates have increased by less than the cash rate

The average rate charged on all outstanding housing and business loans has increased by around 300 basis points since May 2022, 100 basis points less than the cash rate (Graph 3.18). Housing loans (around two-thirds of total credit) account for most of this difference. Lending rates have increased a little more than deposit rates on average.

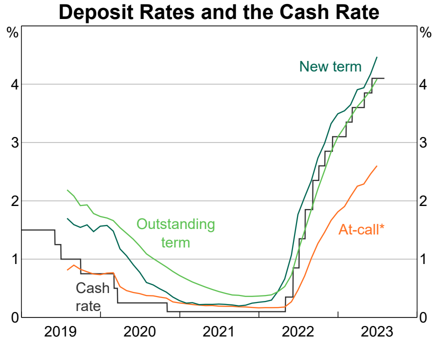
The average outstanding mortgage rate has increased by around 275 basis points since May 2022, 125 basis points less than the cash rate (Graph 3.19). This divergence reflects the high share of fixed-rate housing loans outstanding and, to a lesser extent, the effect of discounting on variable-rate housing loans associated with strong competition between lenders. The share of borrowers rolling off fixed-rate mortgages – taken out two to three years ago at low interest rates – onto much higher rates peaked at just under 5½ per cent of outstanding housing credit in the June quarter; it will stay high for the rest of this year, before declining in 2024 (Graph 3.20). These expiries will see the average outstanding mortgage rate continue to increase as the effect of the rise in the cash rate since May 2022 flows through to a greater share of borrowers.

Competition for housing loans has eased in recent months

Strong competition in the mortgage market has seen the average rate on outstanding variable-rate loans increase by around 65 basis points less than the cumulative increase in the cash rate up to June (Table 3.1). In more recent months, however, there have been signs that competition has eased. In particular, the average variable rate on new housing loans increased by 29 basis points in June; this was more than the

Graph 3.17

Deposit Rates and the Cash Rate



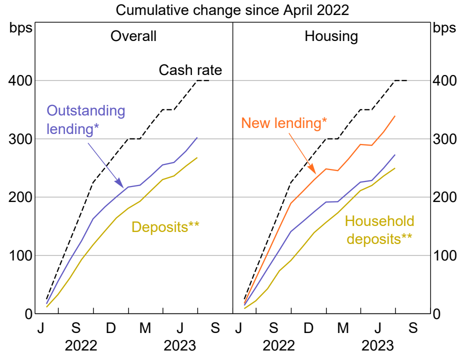
* Excludes deposits in housing loan offset accounts; includes non-interest bearing deposits.

Sources: APRA; RBA.

Graph 3.18

Change in Selected Bank Interest Rates

Cumulative change since April 2022



* Includes non-banks.

** Excludes deposits in housing loan offset accounts, includes non-interest bearing deposits.

Sources: APRA; RBA.

Table 3.1: Average Outstanding Housing Rates

June 2023

	Interest rate June 2023 Per cent	Change since Apr 2022 Basis points	Change since Feb 2020 Basis points
Cash rate	4.10	400	335
Variable-rate loans			
– Owner-occupier	6.24	338	267
– Investor	6.57	336	260
– All variable-rate loans	6.35	337	264
Fixed-rate loans			
– Owner-occupier	2.89	66	–84
– Investor	3.19	60	–82
– All fixed-rate loans	2.99	63	–87
Loans by repayment type[(a)]			
– Principal-and-interest	5.40	272	178
– Interest-only	6.04	280	181

(a) Weighted average across variable- and fixed-rate loans.

Sources: APRA; RBA.

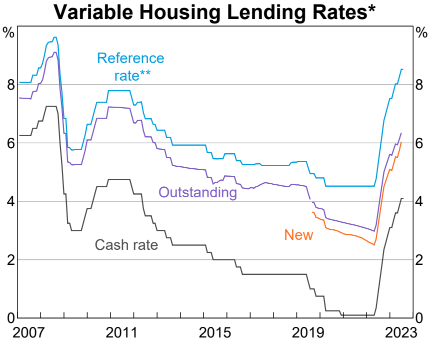
increase in the cash rate, a first for this tightening phase. Also, lenders have reduced discounts on their advertised lending rates and most have now withdrawn cashback offers for new or refinancing borrowers. The share of newly funded housing loans taken out at a fixed interest rate increased a little in the June quarter but remains well below pre-pandemic levels, at around 8 per cent.

Scheduled housing loan payments have increased further

Scheduled mortgage payments – interest plus scheduled principal – increased to 9.4 per cent

Graph 3.19

Variable Housing Lending Rates*



* Reference rates to end July 2023; new and outstanding rates to end June 2023. Series break for new and outstanding loans in July 2019.

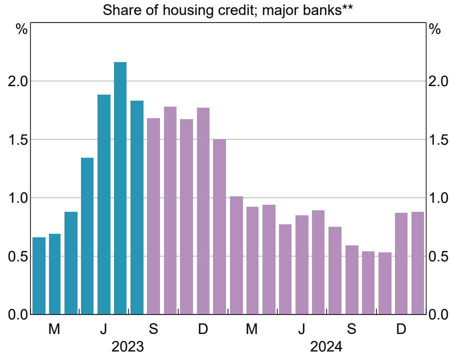
** Major banks' standard reference rates for variable-rate owner-occupier loans.

Sources: APRA; banks' websites; CANSTAR; Perpetual; RBA; Securitisation System.

Graph 3.20

Expiring Fixed-rate Housing Loans*

Share of housing credit; major banks**



* Loans expiring beyond 2024 not available monthly. Blue-coloured bars represent months that have already occurred.

** Value of major banks' housing credit outstanding as at June 2023.

Sources: APRA; major banks; RBA.

of household disposable income in the June quarter (Graph 3.21). Scheduled payments have risen by around 2¼ percentage points of household disposable income since the March quarter of 2022 and will continue to increase as borrowers with expiring fixed-rate loans roll off onto higher rates. Based on cash rate increases to date, scheduled payments are projected to increase to an historical high of around 9.8 per cent of household disposable income by the end of the year and around 10.1 per cent by the end of 2024.

Extra payments into borrowers' offset and redraw accounts declined in the June quarter. Net flows into these accounts have decreased significantly from the highs seen during the pandemic to be noticeably below pre-pandemic averages, which is consistent with pressures on disposable incomes from increases in interest rates and the broader rise in the cost of living (Graph 3.22). While borrowers in aggregate have continued to add to the stock of savings held in these accounts – partly supported by fixed-rate borrowers transferring savings from other sources when their fixed-rate periods expire – some borrowers have been drawing on their stocks of savings to help meet mortgage payments and support consumption in the face of declines in their real disposable incomes.

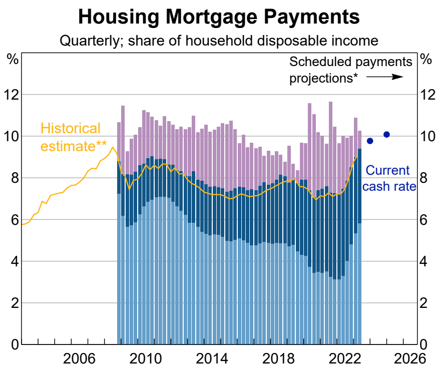
Growth in total credit has stabilised in recent months

Total credit growth has stabilised in recent months, having fallen from its peak in late 2022 (Graph 3.23). Housing credit growth has levelled out, supported by an increase in housing loan commitments alongside a rise in housing prices (see Chapter 2: Domestic Economic Conditions). Business credit growth has also stabilised. Personal credit growth is little changed and personal credit outstanding remains well below levels prior to the pandemic. Outstanding credit has declined as a share of nominal GDP since 2017 (Graph 3.24).

Demand for new housing loans has increased, and refinancing remains high

New housing loan commitments have increased by around 8 per cent since the recent low in February, alongside an uptick in housing prices (Graph 3.25). The recent pick-up in new housing loans has been broadly based across owner-occupiers and investors and across all states and territories. Nonetheless, commitments remain 28 per cent below the January 2022 peak.

Graph 3.21

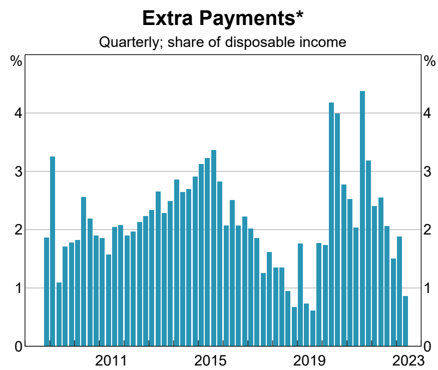


* Projections incorporate fixed-rate roll off to variable rates and the observed gap between cash rate increases and increases to variable loan rates. The current cash rate is 4.1 per cent.

** Estimated scheduled payments using credit foncier model.

Sources: ABS; APRA; RBA.

Graph 3.22



* Payments into offset and redraw accounts; data are break-adjusted and seasonally adjusted.

Sources: ABS; APRA; RBA.

Consistent with the recent pick-up in new housing loans, housing credit growth has shown signs of stabilising in recent months. However, non-bank housing credit growth has fallen sharply since late 2022, reflecting both weakness in new lending and borrowers refinancing away from non-bank lenders towards banks (Graph 3.26). Compared with banks, non-bank lenders have been less able to compete for housing loans due to larger increases in funding costs as seen in wider RMBS spreads over much of the tightening phase (discussed above).

Commitments for external refinancing (switching to a new lender) remain at very high levels. A large share of variable-rate borrowers have sought a better deal on their mortgage as interest rates and the cost of living have increased. External refinancing activity is also being supported by the large number of borrowers rolling off fixed-rate loans, some of whom are switching lenders to obtain a more favourable rate.

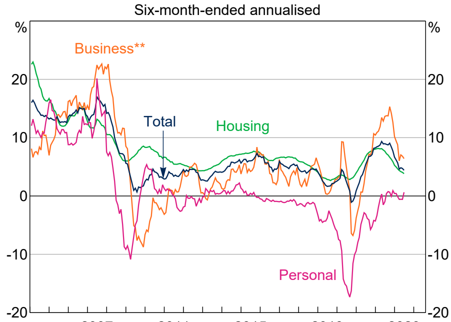
Some borrowers may face difficulties refinancing

At its June meeting, the Council of Financial Regulators (CFR) recognised that some borrowers were facing challenges in refinancing because of a range of difficulties, including in meeting serviceability requirements. The

Graph 3.23

Credit Growth by Sector*

Six-month-ended annualised

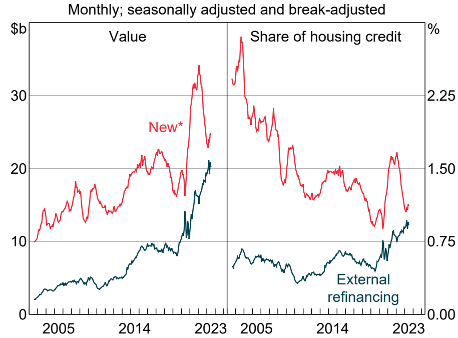


* Seasonally adjusted and break-adjusted; including securitisation.
** Lending to non-financial businesses.
Sources: ABS; APRA; RBA.

Graph 3.25

Housing Loan Commitments

Monthly; seasonally adjusted and break-adjusted

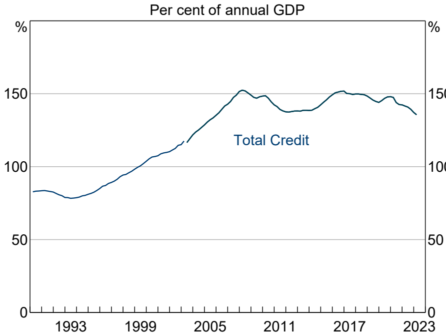


* Excludes refinancing.
Sources: ABS; APRA; RBA.

Graph 3.24

Total Credit*

Per cent of annual GDP

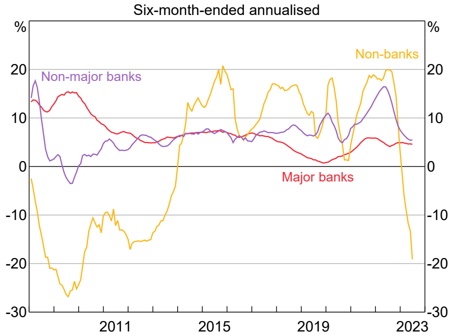


* Seasonally adjusted and break-adjusted; including securitisation. Excluding credit to financial businesses after 2003. Data to March quarter 2023.
Sources: ABS; APRA; RBA.

Graph 3.26

Housing Credit Growth*

Six-month-ended annualised



* Seasonally adjusted and break-adjusted.
Sources: APRA; RBA.

Australian Prudential Regulation Authority (APRA) requires banks to apply a buffer of 3 percentage points above the current loan rate in assessing a new or a refinancing borrower's ability to service mortgage payments. In some cases, this may mean that a borrower cannot refinance to a similar product, even if doing so could reduce their payments.

The CFR supported APRA's assessment that the serviceability buffer is at the appropriate level given the current environment, including the high degree of uncertainty and risks to the economic outlook. The CFR also noted that APRA's prudential framework allows for some limited exceptions to the serviceability policy. In line with this framework, some banks have recently made changes to their exceptions processes to allow refinancing for borrowers who do not meet APRA's serviceability buffer but do meet other criteria (such as a good repayment history and no increase in the loan amount). APRA has written to banks to outline its expectations for the management of exceptions, which include setting prudent limits and monitoring this lending closely. Around 3 per cent of new loans since late 2021 were written under exceptions to banks' serviceability policies.

Interest rates on business loans have risen and growth in business debt has stabilised

Interest rates on business loans have risen in recent months, reflecting increases in the cash rate and BBSW rates (Graph 3.27). BBSW rates are the standard benchmark rates used to price loans to medium and large businesses.

Growth in business debt, and commitments for new business lending, have stabilised in recent months but remain well below their peaks in late 2022 (Graph 3.28). Growth in lending to the property services industry has slowed, consistent with weaker conditions in commercial property markets; however, this has been partly offset by increased growth in lending to goods-related industries, particularly agricultural businesses.

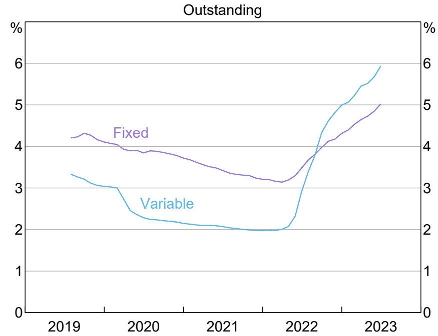
Australian equity prices have increased

The ASX 200 index has increased by 3 per cent since May on a total return basis and is around its previous peak in February (Graph 3.29). Australian equity prices have underperformed the United States and other international equity markets since May. This partly reflects the composition of the Australian market, which has a smaller IT sector and a larger resources sector compared with many other markets.

Graph 3.27

Business Lending Rates

Outstanding

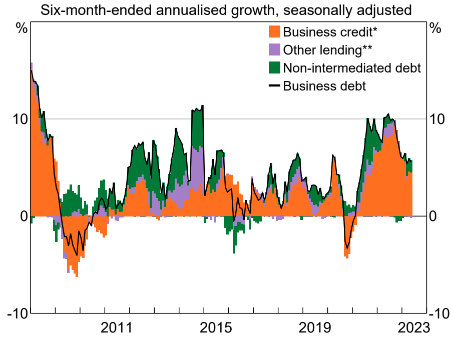


Sources: APRA; RBA.

Graph 3.28

Business Debt

Six-month-ended annualised growth, seasonally adjusted



* Excludes lending to financial businesses.

** Lending to large businesses by institutions that do not report to APRA.

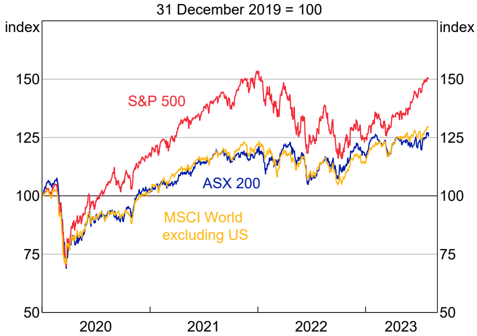
Sources: APRA; Bloomberg; RBA; Refinitiv.

Information technology stocks have increased notably over recent months, reflecting increased investor interest in stocks thought to be likely to benefit from artificial intelligence (Graph 3.30). Energy stocks have also risen alongside a rise in oil prices. Financials stocks have rebounded from lows reached during the overseas banking stress earlier in the year, supported by stronger-than-expected earnings results in the United States of late. By contrast, health care share prices declined alongside profit forecast downgrades.

Graph 3.29

Total Return Indices

31 December 2019 = 100

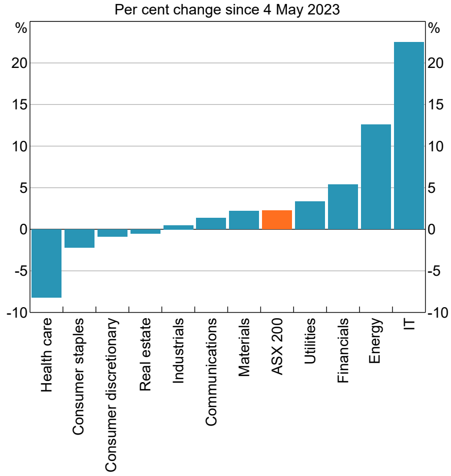


Sources: Bloomberg; RBA; Refinitiv Datastream.

Graph 3.30

Australian Equity Prices

Per cent change since 4 May 2023



Source: Bloomberg.

Equity raisings remain subdued

Equity raisings remained subdued in the first half of the year following low activity in 2022, including the lowest annual value raised from initial public offerings (IPOs) in the past two decades. Overall, around $140 million was raised through IPOs in the first half of 2023, largely in the resources sector; this follows relatively strong IPO activity in 2021 (Graph 3.31).

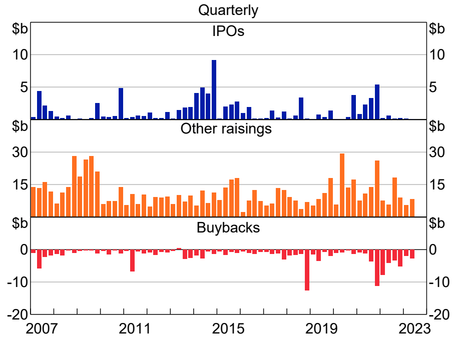
The Australian dollar has depreciated of late

On a TWI basis, the Australian dollar is around its level at the May *Statement*, while it is lower against the US dollar at below US$0.66 (Graph 3.32). The exchange rate had appreciated alongside an increase in the yield differential between AGS and those of its major trading partners following increases in Australia's policy rate in May and June. However, more recently, the exchange rate has depreciated following weaker-than-expected domestic data, including for inflation, and after the cash rate was left unchanged in August. At the same time, concerns about the strength of China's economic recovery have weighed on the Australian dollar versus other currencies, and the RBA Index of Commodity Prices remains well below its levels from earlier in the year.

Graph 3.31

Australian Equity Raisings*

Quarterly



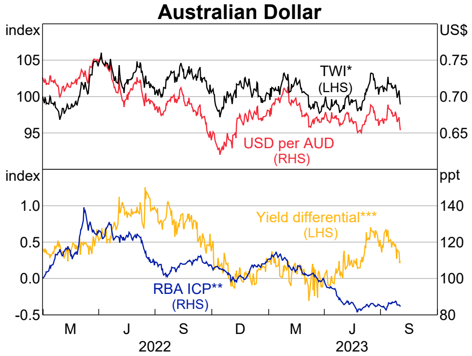
* All listed companies.

Sources: ASX; RBA.

The Australian dollar TWI has been supported by an appreciation against the Japanese yen and Chinese renminbi over recent months, which together account for around 40 per cent of the TWI basket (Graph 3.33). In Japan, yields have remained low as the Bank of Japan has maintained highly accommodative policy settings. In China, bond yields have fallen alongside concerns about the outlook for the Chinese economy and as Chinese authorities have eased monetary policy (see Chapter 1: The International Environment).

Graph 3.32

Australian Dollar

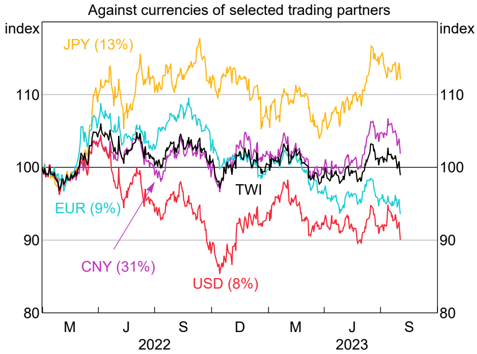


* Trade-weighted index; 31 December 2021 = 100.
** Index of Commodity Prices (USD terms); 31 December 2021 = 100.
*** Three-year Australian sovereign yield less yields of the United States, Japan and Germany, weighted by GDP.
Sources: Bloomberg; RBA; Yieldbroker.

Graph 3.33

Australian Dollar*

Against currencies of selected trading partners



* Indexed to 31 December 2021 = 100; TWI weights in parentheses.
Sources: Bloomberg; RBA.

Australia's financial account deficit narrowed in the March quarter

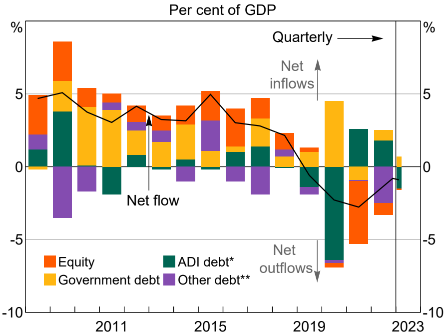
The narrowing of Australia's financial account deficit in the March quarter of 2023 was caused by a smaller net outflow of capital compared with the December 2022 quarter (Graph 3.34). Net capital outflows were partly driven by a withdrawal of deposits from foreign banks to support intragroup funding and liquidity management activities during the quarter, alongside the collapse of several US banks and Credit Suisse.

Australia's net foreign liability position as a percentage of GDP decreased over the March quarter to its lowest level since the 1980s (Graph 3.35). The recent decline was driven by a small widening in Australia's net foreign equity asset position, partly reflecting valuation effects associated with an increase in foreign equity prices and the depreciation of the Australian Dollar. The net income deficit, which comprises net payments made on Australia's net foreign liability position, widened slightly to around 4½ per cent of GDP in the March quarter, and remains at historically high levels. The increase in the net income deficit reflected a decline in primary income credits driven by lower profits on Australian-owned overseas assets across most sectors.

Graph 3.34

Net Capital Flows

Per cent of GDP

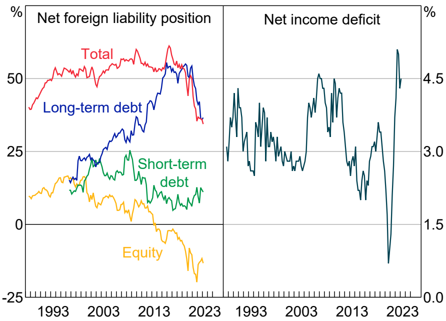


* Includes derivative settlement, adjusted for the US dollar swap facility in 2008–2009 and 2020.
** Includes public corporations and private sector.
Sources: ABS; RBA.

Graph 3.35

Net Foreign Position and Payments

Per cent of GDP



Sources: ABS; RBA.

Endnote

[1] See Australian Competition and Consumer Commission (2023), 'Retail Deposits Inquiry 2023'.

4. Inflation

Inflation declined by more than expected in the June quarter, though it remains high and broadly based. An easing in global upstream cost pressures and a moderation in domestic demand led to a notable decline in goods price inflation in the quarter. However, services inflation remained strong and rent inflation has increased in response to tight conditions in the rental market. Measures of short-term inflation expectations have moved lower in recent months alongside the decline in inflation, though they remain elevated. Most measures of medium- and long-term inflation expectations remain consistent with the inflation target.

Wages growth reached its highest rate in a decade in the March quarter, driven by a tight labour market, high inflation and the implementation of some new public sector wage policies. Timely indicators suggest that wages growth remained steady over the June quarter ahead of the Fair Work Commission (FWC) decision taking effect in the September quarter. Growth in broad measures of labour costs have been stronger than growth in base wages as firms continued to use bonus payments to attract or retain staff and to compensate for cost-of-living pressures. Unit labour costs increased at their strongest pace in several decades (outside of the pandemic period) as productivity growth continued to be weak.

Inflation eased further in the June quarter

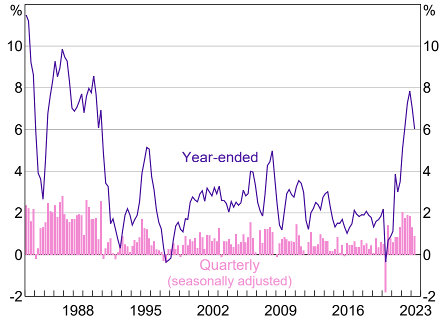
The Consumer Price Index (CPI) increased by 0.9 per cent in the June quarter (in seasonally adjusted terms) and by 6 per cent over the year; this was less than expected three months ago. As such, inflation continued to decline from its peak of 7.8 per cent in the December quarter of 2022 but remains high (Graph 4.1; Table 4.1).

High inflation continues to be broadly based, with a wide range of items having contributed to inflationary pressures over the past year (Graph 4.2). The share of CPI prices growing faster than 3 per cent in annualised terms declined to around 50 per cent in the June quarter, which is higher than its pre-pandemic share (Graph 4.3).

Measures of underlying inflation (which remove the effect of irregular or temporary price changes) also eased further in the June quarter but remain high. Trimmed mean inflation was 0.9 per cent in the quarter and 5.9 per cent over the year, down from a peak of 6.9 per cent in late 2022 (Graph 4.4; Table 4.1).

Graph 4.1

Consumer Price Inflation*



* Excludes interest charges prior to the September quarter of 1998; adjusted for the tax changes of 1999–2000.

Sources: ABS; RBA.

Table 4.1: Measures of Consumer Price Inflation

Per cent

	Quarterly[a]		Year-ended[b]	
	June quarter 2023	March quarter 2023	June quarter 2023	March quarter 2023
Consumer Price Index	0.8	1.4	6.0	7.0
Seasonally adjusted CPI	0.9	1.3	–	–
– Tradables	0.8	0.6	4.4	6.1
– Tradables (excl. volatile items)[c]	0.9	0.8	5.8	6.7
– Non-tradables	1.0	1.7	6.9	7.5
Selected underlying measures				
Trimmed mean	0.9	1.3	5.9	6.6
Weighted median	1.0	1.3	5.5	5.9
CPI excl. volatile items[c]	0.9	1.5	6.5	7.3

(a) Except for the headline CPI, quarterly changes are based on seasonally adjusted data; those not published by the ABS are calculated by the RBA using seasonal factors published by the ABS.

(b) Year-ended changes are based on non-seasonally adjusted data, except for the trimmed mean and weighted median.

(c) Volatile items are fruit, vegetables and automotive fuel.

Sources: ABS; RBA.

Fuel prices declined

Automotive fuel prices declined a little in the June quarter due to falls in diesel prices and were 3½ per cent lower over the year (Graph 4.5). The sharp decline in oil prices since the middle of last year has been partly offset by increases in wholesale and refining margins and the reintroduction of the fuel excise in September 2022. Fuel prices in the September quarter to date are similar to the June quarter average.

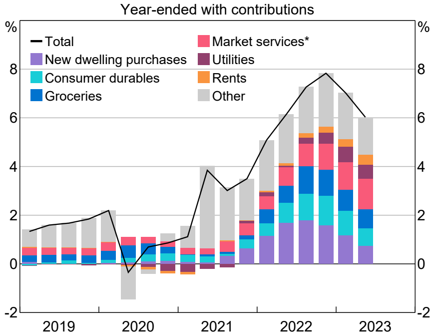
Goods price inflation slowed further in response to easing upstream cost pressures

Goods price inflation eased further in the June quarter, particularly for consumer durables. The earlier easing in global cost pressures is flowing

Graph 4.2

CPI Inflation

Year-ended with contributions



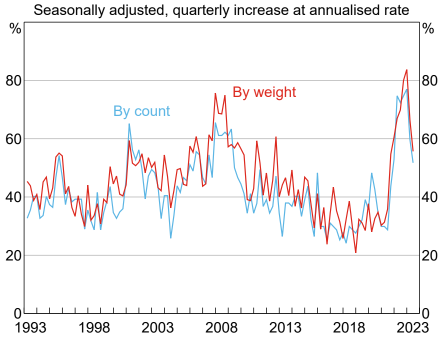
* Excludes domestic holiday travel & accommodation and telecommunications.

Sources: ABS; RBA.

Graph 4.3

CPI Items Rising by More than 3 Per Cent*

Seasonally adjusted, quarterly increase at annualised rate



* Adjusted for the tax changes of 1999–2000.

Sources: ABS; RBA.

through to domestic goods inflation, alongside the effects of slow growth in domestic demand. These factors are expected to result in a further slowing in goods price inflation in the period ahead, consistent with the experience overseas. Global supply chain issues have largely been resolved and the costs of international freight, raw materials and some imported goods have declined significantly. Disinflation from these global forces has been partly offset by recent increases in domestic labour and energy costs.

New dwelling cost inflation has declined materially over the past year, averaging around 1 per cent on a quarterly basis over the first half of 2023 – well below the quarterly outcomes of around 5 per cent observed in the first half of 2022. The easing reflected continued improvement in the availability of building materials and weaker demand for new dwellings following the increases in interest rates and the costs of land and construction. Prices for building materials increased by around ½ per cent in the June quarter to be around 7½ per cent higher over the year; this is slower than the pace of increases observed over 2022 (Graph 4.6). However, labour shortages and associated labour costs remain a source of pressure for builders.

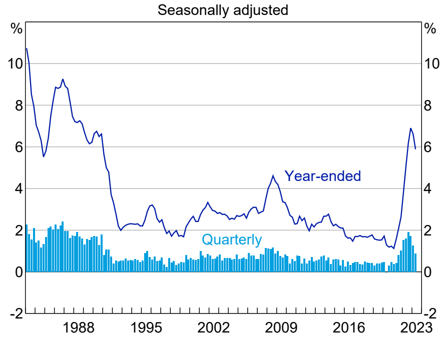
Consumer durables inflation declined significantly in the June quarter to be around 4 per cent over the year, compared with a peak of 7 per cent in the December quarter of 2022 (Graph 4.7). This reflected an easing in global upstream costs flowing through to consumer prices. In addition, consumers are limiting their discretionary spending due to cost-of-living pressures. Businesses have responded by leaving prices unchanged or offering discounts. Clothing and motor vehicle prices declined in the quarter, while many other durable prices were unchanged. By contrast, furniture and furnishing prices continued to increase strongly (Graph 4.8).

Grocery prices (excluding fruit and vegetables) increased by 1.7 per cent in the June quarter, to be 9 per cent higher over the year (Graph 4.7).

Graph 4.4

Trimmed Mean Inflation*

Seasonally adjusted



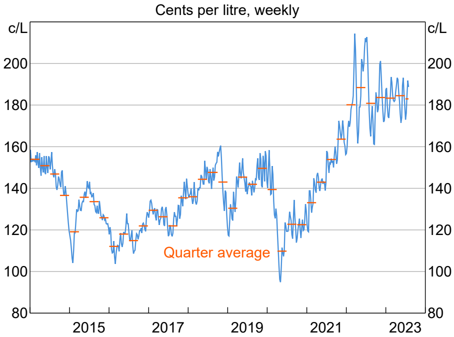
* Excludes interest charges prior to the September quarter of 1998 and deposit & loan facilities; adjusted for the tax changes of 1999–2000.

Sources: ABS; RBA.

Graph 4.5

Unleaded Petrol Prices

Cents per litre, weekly

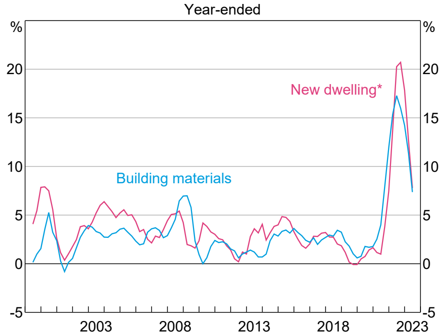


Sources: Australian Institute of Petroleum; RBA.

Graph 4.6

New Dwelling and Building Materials Inflation

Year-ended



* Adjusted for the tax changes of 1999–2000.

Sources: ABS; RBA.

Supermarkets continued to pass through higher prices paid to suppliers. Several food categories, particularly those requiring a greater degree of processing such as breads and cereals, continued to record strong price increases in the quarter. Prices for fruit and vegetables and meat and seafood increased a little (Graph 4.9).

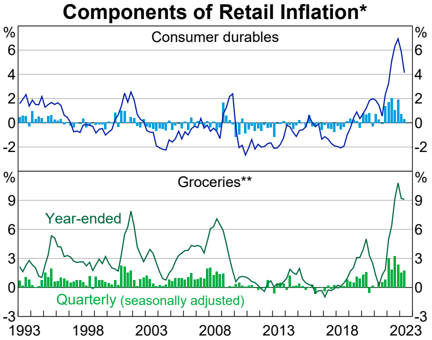
Services inflation remained strong

Services inflation was strong and broadly based in the June quarter, reflecting cost pressures and a still-high level of demand. Market services prices (excluding domestic travel and accommodation, and telecommunications) – which covers around one-fifth of the CPI basket – rose by 2 per cent in the quarter to be 7 per cent higher over the year (Graph 4.10). The prices of these services are generally among the most sensitive to domestic labour costs, although increases in non-labour costs such as materials and transport have also been an important factor for some services recently.

Within market services, prices for insurance and financial services increased by 3 per cent in the June quarter, underpinned by higher premiums and property transfer-related fees (such as stamp duty and real estate agent fees). Insurance premiums have increased significantly over recent quarters reflecting higher replacement costs of insured items, including costs of repairs and reinsurance, and increased claims owing to unfavourable weather. Prices for

Graph 4.7

Components of Retail Inflation*

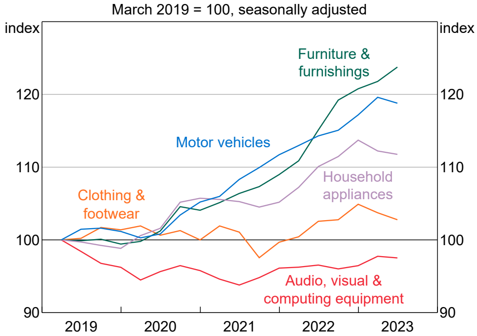


* Adjusted for the tax changes of 1999–2000.
** Excludes fruit & vegetables.
Sources: ABS; RBA.

Graph 4.8

Consumer Durables Prices

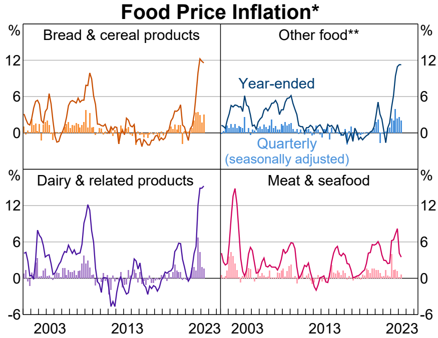
March 2019 = 100, seasonally adjusted



Sources: ABS; RBA.

Graph 4.9

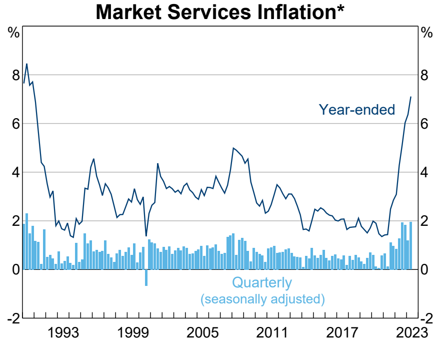
Food Price Inflation*



* Adjusted for the tax changes of 1999–2000.
** Includes products such as eggs, jams, oils, snacks etc.
Sources: ABS; RBA.

Graph 4.10

Market Services Inflation*



* Excludes domestic holiday travel & accommodation and telecommunications; adjusted for the tax changes of 1999–2000.
Sources: ABS; RBA.

meals out and take-away also increased strongly in the quarter to be 8 per cent higher over the year. While overseas holiday travel costs also increased strongly, prices for domestic holiday travel and accommodation declined due to increased discounting in airfares and lower accommodation prices amid weaker demand (Graph 4.11).

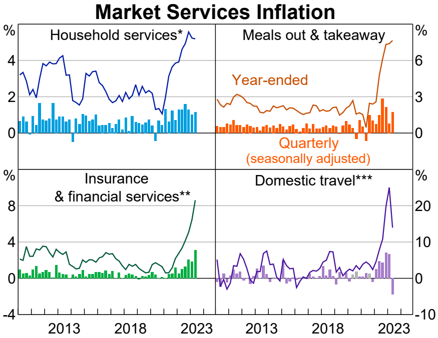
Rents increased by 2½ per cent in the June quarter and by 7 per cent over the year – the strongest annual increase since 2009 (Graph 4.12). High rent inflation is consistent with tight rental market conditions across the country. Rent increases in regional areas have outpaced capital cities since the onset of the COVID-19 pandemic (Graph 4.13). Within capital cities, rent inflation has been higher for apartments than for detached houses recently. High advertised rents and historically low vacancy rates are expected to contribute to a further pick-up in CPI rent growth in the year ahead.

Utility prices were little changed in the quarter

Electricity and gas prices were little changed in the June quarter, though they have increased sharply over the past year (Graph 4.14). Retail electricity prices will increase further in the September quarter as higher average wholesale costs recorded last year are passed through to prices. However, the effect of these increases on the CPI in the 2023/24 financial year will be partially offset by the energy rebates offered to households under the Australian Government's Energy Price Relief Plan and various state government measures.

In the CPI basket, 'administered prices' are (at least partly) regulated or relate to goods and services for which the public sector is a significant provider. They include categories such as health, education and child care, as well as utilities. Administered prices (excluding utilities) were little changed in the June quarter,

Graph 4.11



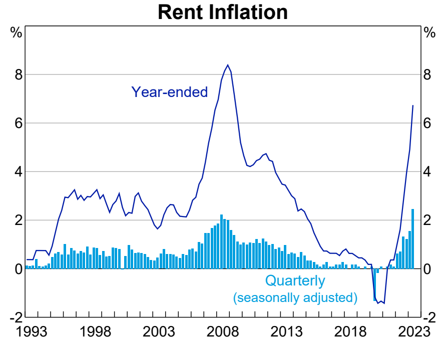
* Includes home cleaning, vehicle repairs, hairdressing, veterinary services, sports and leisure services.

** Excludes deposit & loans to June quarter of 2011.

*** Imputed using headline CPI in the June and September quarters of 2020 and September quarter of 2021.

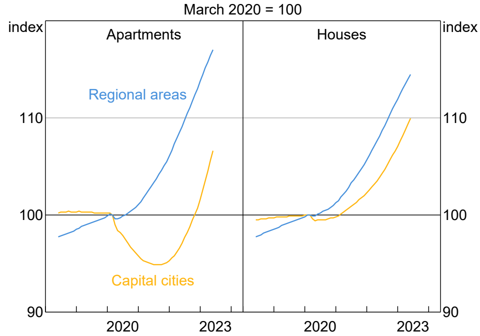
Sources: ABS; RBA.

Graph 4.12



Sources: ABS; RBA.

Graph 4.13



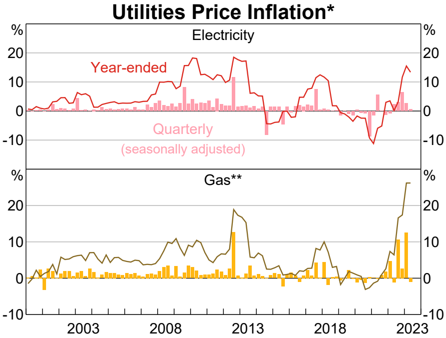
* Alternative stratification approach; excluding rent assistance and public rents.

Sources: ABS; RBA.

to be 5 per cent higher over the year. Prices declined for health items as several health insurers delayed their usual April annual premium increase. Increased subsidies under the Australian Government's Pharmaceutical Benefits Scheme also reduced inflation. State government pre-school fee relief programs led to a decline in the measured price for pre-school education. By contrast, there were moderate price increases for child care, secondary education and state government charges related to property rates and charges and urban transport fees (Graph 4.15).

Graph 4.14

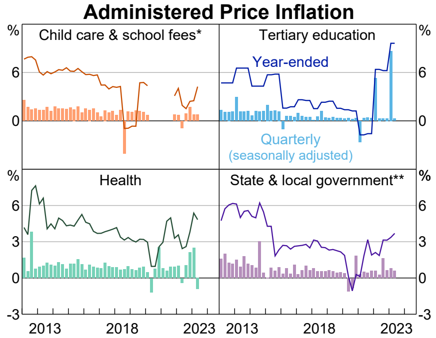
Utilities Price Inflation*



* Adjusted for the tax changes of 1999–2000.
** Includes other household fuels.
Sources: ABS; RBA.

Graph 4.15

Administered Price Inflation



* Excludes volatile periods from June 2020 to September 2021 caused by the government's free child care policy.
** Includes urban transport fares, property rates & charges and other services in respect of motor vehicles.
Sources: ABS; RBA.

The monthly CPI indicator points to easing inflationary pressures

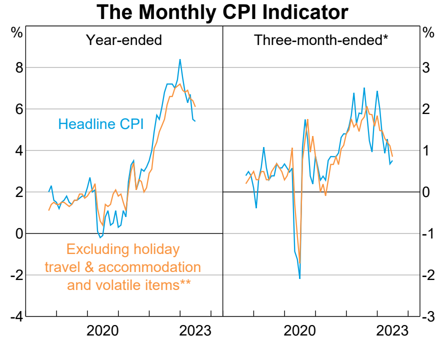
The CPI monthly indicator for June showed an easing of inflationary pressures through the quarter, with the year-ended rate slowing to 5.4 per cent in June from 6.3 per cent in March (Graph 4.16). A similar easing is apparent in the measure excluding volatile items and holiday travel and accommodation. The easing in the monthly CPI indicator between April and June was largely driven by disinflation in goods prices and domestic holiday travel and accommodation.

Short-term inflation expectations have declined but remain elevated

Household perceptions of recent inflation – that is, what households believe inflation has been over the past year – have increased to around 9 per cent, which is slightly higher than the peak in actual CPI inflation recorded in the December quarter of 2022. By contrast, household expectations for inflation over the year ahead have eased to around 5 per cent (Graph 4.17). This difference suggests that households expect much of the current high inflation to be temporary. Other measures of short-term inflation expectations have also declined from their mid-2022 peaks but remain above the Bank's inflation target. Most medium- and long-

Graph 4.16

The Monthly CPI Indicator



* Headline CPI is seasonally adjusted.
** Volatile items are automotive fuel and fruit & vegetables.
Sources: ABS; RBA.

term inflation expectation measures remain consistent with the Bank's inflation target (Graph 4.18).

Wages growth was high over the year to the March quarter …

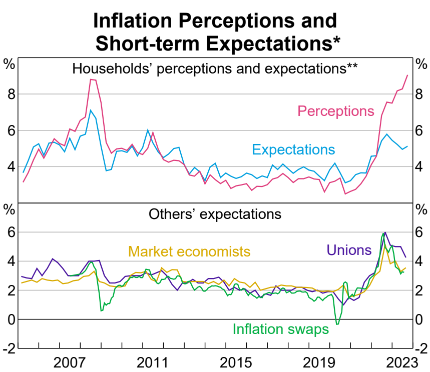
The Wage Price Index increased by 0.8 per cent in the March quarter and 3.7 per cent in year-ended terms (Graph 4.19). This was the highest rate of year-ended wages growth since 2012, reflecting a tight labour market, high inflation outcomes and the implementation of some new public sector wage policies. Public sector wages rose by 0.9 per cent in the quarter, to be 3 per cent higher over the year; the stronger quarterly outcome reflected the implementation of some new enterprise agreements. Private sector wages growth increased by 0.8 per cent in the March quarter and 3.8 per cent over the year.

Of jobs that experienced a wage change in the year to the March quarter, around one-third were larger than 4 per cent (Graph 4.20); by contrast, less than 10 per cent of wage changes were above 4 per cent in the years immediately preceding the pandemic. The average size of wage increases (for those jobs that received a wage change) were around decade-high levels in the March quarter, at 4 per cent in the private sector and 3 per cent in the public sector. These outcomes reflected ongoing labour market tightness and the implementation of award and minimum wage increases in the September and December quarters of 2022.

While wages growth for those on enterprise bargaining agreements (EBAs) increased notably in the March quarter, it continued to lag behind growth in award and individual arrangement wages in year-ended terms (Graph 4.21). Much of that difference reflects the multi-year structure of EBAs, which cause a lag in the flow-through of wage pressures to agreements.

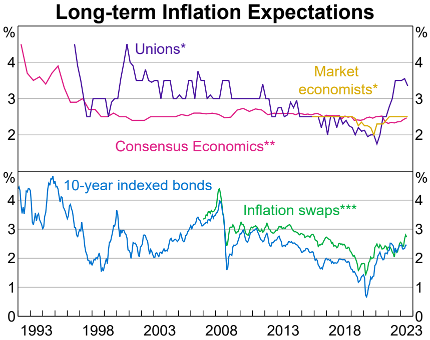
Broad measures of labour costs have continued to grow at around their fastest rate in over a

Graph 4.17



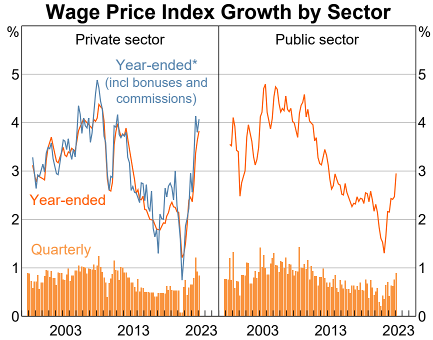
* Expectations are for one year ahead.
** Based on the middle 70 per cent distribution; quarterly average.
Sources: Australian Council of Trade Unions; Bloomberg; Melbourne Institute; RBA; Workplace Research Centre.

Graph 4.18



* Average over the next 5–10 years.
** Average over 6–10 years in the future.
*** 5-years to 10-years forward.
Sources: Australian Council of Trade Unions; Bloomberg; Consensus Economics; RBA; Workplace Research Centre; Yieldbroker.

Graph 4.19



* Non-seasonally adjusted.
Source: ABS.

decade. Bonus-inclusive wages measures increased at a faster pace than base wages, consistent with reports that employers have been using bonuses to attract or retain staff amid the tight labour market and to compensate for cost-of-living pressures. Compensation of employees – which includes the effects of wages growth as well as increases in employment (both headcount and hours worked) – rose by 11 per cent over the year to the March quarter (Graph 4.22).

Labour productivity continued to decline in the March quarter as total hours worked remained at high levels and activity growth weakened (Graph 4.23). Year-ended productivity growth has been weak across most industries; however, it is difficult to assess underlying trends in productivity growth over short time periods with the available data. The extent of the economy-wide slowdown in productivity growth is further complicated by the pandemic-related shifts in the labour force between industries. Weak measured productivity growth contributed to unit labour costs growing at the strongest rate in several decades (Graph 4.24).

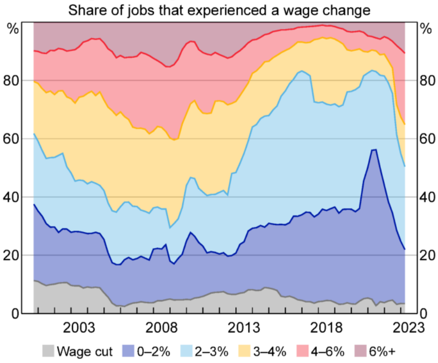
… and appears to have held steady in the June quarter

Timely indicators suggest that wages growth was broadly steady in the June quarter ahead of the implementation of the FWC's award and minimum wage changes in July (Graph 4.25).

Graph 4.20

Wage Changes of Different Sizes*

Share of jobs that experienced a wage change



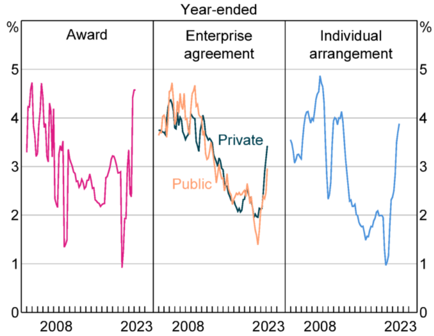
* Smoothed using a four-quarter trailing average.

Sources: ABS; RBA.

Graph 4.21

Wages Growth by Pay-setting Method*

Year-ended



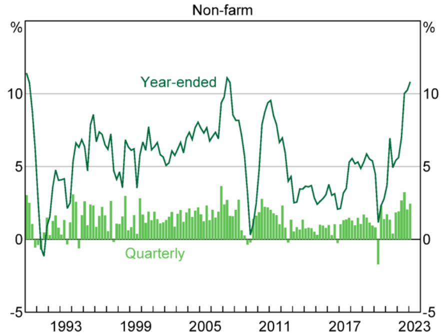
* Excludes bonuses and commissions.

Sources: ABS; RBA.

Graph 4.22

Compensation of Employees Growth

Non-farm

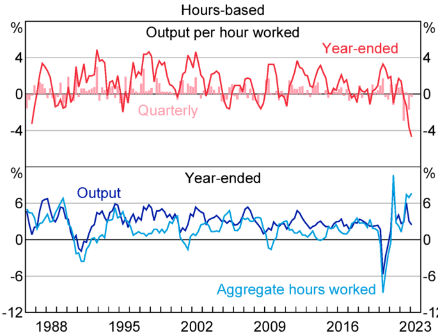


Source: ABS.

Graph 4.23

Non-farm Labour Productivity Growth

Hours-based



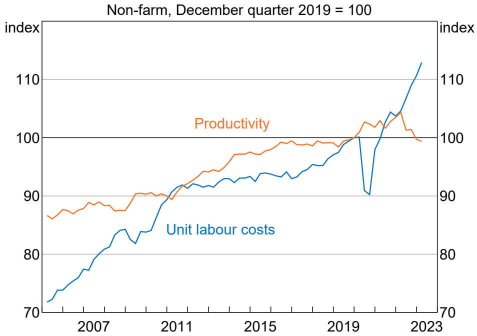
Source: ABS.

Firms in the Bank's liaison program continue to report that wages growth has been steady at around 4 per cent, with wages growth expectations for the year ahead also stable at 4 per cent. This is consistent with other timely indicators of wages growth, which have also been little changed over the quarter. Market economists and union officials expect wages growth to be around 3½ to 4 per cent over the year ahead (Graph 4.26). Beyond that, both market economists and unions expect wages growth to ease a little to around 3¼ to 3¾ per cent.

Graph 4.24

Unit Labour Costs and Productivity

Non-farm, December quarter 2019 = 100

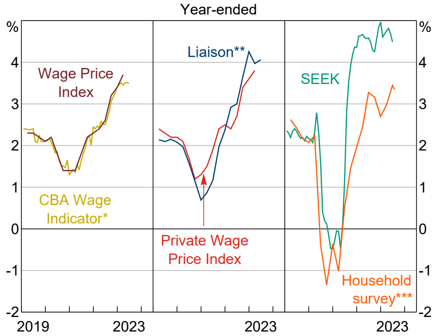


Sources: ABS; RBA.

Graph 4.25

Timely Measures of Wages Growth

Year-ended



* Changes in base wages based on a sample of CBA retail banking transactions.

** Private sector; trimmed mean; rescaled to have the same mean as the private Wage Price Index.

*** Based on the 30 per cent trimmed mean distribution.

Sources: ABS; CBA; Melbourne Institute; RBA; SEEK.

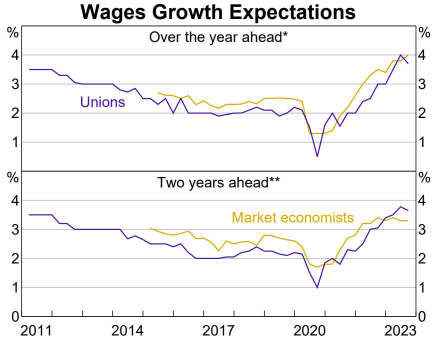
Wages growth in newly lodged enterprise agreements, which provides an indication about the direction of average enterprise agreement wages growth, eased a little to 3.4 per cent in the June quarter but remains elevated compared with pre-pandemic levels (Graph 4.27). Firms in the Bank's liaison program have noted that new enterprise agreements are typically including higher average wage increases than prior agreements due to the tighter labour market and high inflation. However, there is no evidence from liaison of a higher share of firms linking wage outcomes to the CPI. Around 5 per cent of employees on federally registered enterprise agreements have wages explicitly linked to the CPI (with a similar share among newly lodged agreements as the outstanding stock of all agreements).

Award and minimum wages increased in July

In June, the FWC announced a 5.75 per cent increase to modern award wages, effective from 1 July (Graph 4.28). The national minimum wage increased by 8.6 per cent, consisting of a 5.75 per cent headline increase and an additional increase from a technical readjustment that realigned the minimum wage to a different wage classification. It is estimated that around 30 per cent of employees are

Graph 4.26

Wages Growth Expectations



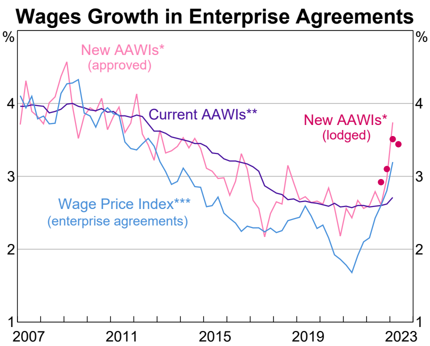
* The current calendar year for union expectations.

** The next calendar year for union expectations.

Sources: Australian Council of Trade Unions; RBA; Workplace Research Centre.

directly or indirectly affected by these increases, though the share of the aggregate wage bill that is impacted is lower; for the most part, these increases will flow through to wages growth in the September quarter. Previously announced increases to modern award wages for direct care workers and some other staff in the aged care sector will also impact wages growth in the September quarter; the 15 per cent increase took effect on 30 June 2023.

Graph 4.27



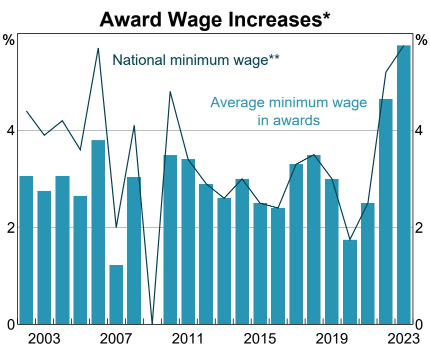
* Quantifiable average annualised wage increases (AAWIs) in new FWC-approved and federally registered enterprise agreements; dots represent quarterly average of AAWIs in newly lodged agreements; latest dot is current quarter to date.

** AAWIs in the total stock of nominally current, FWC-approved and federally registered enterprise agreements.

*** Year-ended growth; excludes bonuses and commissions.

Sources: ABS; Department of Employment and Workplace Relations; FWC; RBA.

Graph 4.28



* RBA calculations; the time period over which each increase applies varies.

** There was an additional 2.7 per cent increase to the national minimum wage in 2023 due to a realignment of the relevant wage rate.

Sources: AFPC; AIRC; FWC; RBA.

Increases to public sector wage policies will support wages growth in the period ahead

Changes to wage policies in a number of jurisdictions will continue to flow through to wages growth over coming quarters. The New South Wales Government has announced a 4 per cent wage increase for most public sector workers for the 2023/2024 financial year; it has also set up a task force that will consider setting wages through bargaining as part of broader reforms of the state's industrial relations system. The Queensland Government has continued to implement its wage offer across the public sector, which consists of a 4 per cent increase for the first two years of the agreement and a 3 per cent increase in the year after, as well as cost-of-living bonuses. The Australian Government has proposed wage increases of 4 per cent in the first year of the agreement, 3.5 per cent in the second year and 3 per cent in the third year, though negotiations with employees are ongoing.

Real incomes continued to decline in the March quarter

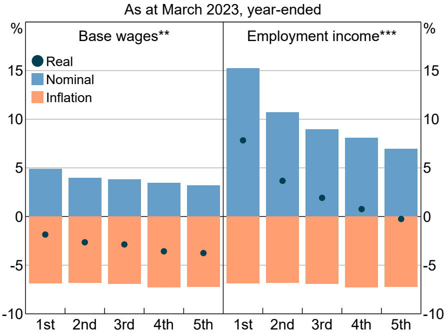
Real (inflation-adjusted) labour income declined further in the March quarter as labour income increased by less than consumer prices over the year. Real wages declined by around 3 per cent over the year. The declines have been smaller for lower wage earners; this is because nominal wages growth has been larger for this group (due in part to the FWC award wage decision), while the rise in inflation has been similar across the income distribution and household types. Administrative employment data suggests that lower income workers experienced stronger earnings growth than higher income workers in the year to the March quarter (Graph 4.29). Across all quintiles, nominal employment income growth has been stronger than base wages growth, which likely reflects increases in hours worked (especially for those on lower incomes), people switching to higher paid jobs or receiving promotions, and firms offering additional payments such as overtime or cost-of-living bonuses.

Growth in cost-of-living indices eased in the June quarter across most household types but remains high (Graph 4.30). Rising living costs tend to impact lower income households more than other groups as they typically have the most constrained budgets, spend a greater proportion of their income on essential items and have lower financial buffers. The experience of individual households varies widely and some workers who have remained in the same job and maintained the same hours will have seen their real incomes decline significantly over the past year.

Graph 4.29

Growth in Real Earnings by Quintile*

As at March 2023, year-ended



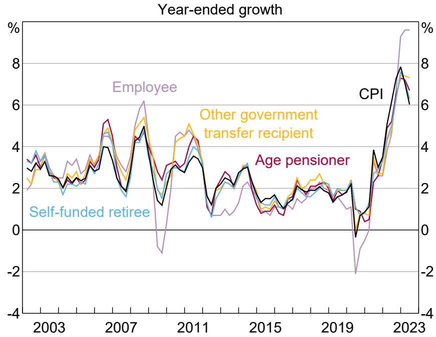
* Inflation quintiles constructed by income levels.
** Total hourly rates of pay, excluding bonuses and commissions; quintiles constructed using hourly wage rates in the previous period.
*** Single Touch Payroll employment income per worker for those with a 2019/20 tax return; percentiles constructed using employment income in the current period; estimates are based on the percentile at the mid-point of each group; administrative data on incomes are not necessarily directly comparable to published aggregate estimates.

Sources: ABS; ATO; RBA.

Graph 4.30

Selected Living Cost Indexes by Household Type*

Year-ended growth



* The living cost indexes include mortgage interest payments (which are not included in the CPI) but exclude the construction costs of new dwellings (which are included in the CPI); other financial and insurance items also differ between the indexes.

Source: ABS.

5. Economic Outlook

Global growth is forecast to remain well below its historical average over the next two years, as the lagged effects of monetary policy tightening continue to weigh on demand. The central forecast for growth in Australia's major trading partners has been revised down, partly because China's post-COVID-19 recovery has been weaker than expected (see Chapter 1: The International Environment).

Growth in economic activity in Australia is forecast to remain subdued over the rest of the year as cost-of-living pressures and the rise in interest rates continue to weigh on domestic demand (Table 5.1). It is expected that growth will then increase gradually over the remainder of the forecast period, supported by an easing in these headwinds and a pick-up in household wealth. Labour market conditions have been very tight but these are forecast to ease, with an increase in both the unemployment and underemployment rate over coming years as a result of subdued economic growth. Inflation is forecast to decline to be around 3¼ per cent by the end of 2024 and to be back within the 2–3 per cent target range in late 2025. Goods prices have accounted for most of the decline in inflation so far and this is expected to continue in the near term as the resolution of supply disruptions flows through to prices paid by consumers. By contrast, electricity costs will increase, and high services inflation is forecast to persist. There are several key domestic uncertainties that may result in different outcomes than forecast. These are discussed at the end of this chapter.

The forecasts are based on some technical assumptions. The path for the cash rate reflects expectations derived from surveys of professional economists and financial market pricing, with an assumed peak in the cash rate of around 4¼ per cent by the end of 2023 before declining to 3¼ per cent by the end of 2025. This compares with an assumed peak in the cash rate of 3¾ per cent in the May *Statement*. The exchange rate is assumed to be unchanged at its current level, which is broadly unchanged relative to its level at the May *Statement* on a trade-weighted basis. Petrol prices are assumed to be broadly unchanged around their June quarter average. The level of the population has been revised higher, reflecting stronger-than-expected growth in recent quarters; over the next couple of years, year-ended population growth is expected to decline from its recent rate of around 2 per cent back to its pre-pandemic average of around 1.5 per cent.

Inflation in Australia is easing

Consumer price inflation in Australia continued to decline in the June quarter but remains high and broadly based (Graph 5.1). While goods price pressures have continued to ease, services inflation remains persistently high, as has been the case overseas. The outlook for headline and underlying inflation remains similar to a few months ago. Recent evidence of stronger growth in the measure of unit labour costs (partly driven by weaker productivity) and higher rent inflation have largely offset the effects of the small downgrades to the forecasts for economic activity and weaker-than-expected

Table 5.1: Output Growth and Inflation Forecasts[a]

Per cent

	Year-ended					
	June 2023	Dec 2023	June 2024	Dec 2024	June 2025	Dec 2025
GDP growth	1½	1	1¼	1¾	2	2¼
(previous)	(1¾)	(1¼)	(1½)	(1¾)	(2)	(n/a)
Unemployment rate[b]	3.6	4	4¼	4½	4½	4½
(previous)	(3½)	(4)	(4¼)	(4½)	(4½)	(n/a)
CPI inflation	6.0	4¼	3½	3¼	3	2¾
(previous)	(6¼)	(4½)	(3½)	(3¼)	(3)	(n/a)
Trimmed mean inflation	5.9	4	3¼	3	3	2¾
(previous)	(6)	(4)	(3¼)	(3)	(3)	(n/a)
	Year-average					
	2022/23	2023	2023/24	2024	2024/25	2025
GDP growth	3	1½	1	1¼	1¾	2
(previous)	(3¼)	(1¾)	(1¼)	(1½)	(1¾)	(n/a)

(a) Forecasts finalised 2 August. The forecasts are conditioned on a path for the cash rate broadly in line with expectations derived from surveys of professional economists and financial market pricing. The cash rate is assumed to peak at around 4¼ per cent before declining to around 3¼ per cent by the end of 2025. Other forecast assumptions (assumptions as of May *Statement* in parenthesis): TWI at 61 (60); A$ at US$0.66 (US$0.66); Brent crude oil price at US$80bbl (US$78bbl). The rate of population growth has been revised higher in the near term but is expected to gradually decline to around its pre-pandemic average. Forecasts are rounded to the nearest quarter point. Shading indicates historical data, shown to the first decimal point.

(b) Average rate in the quarter.

Sources: ABS; RBA.

goods price inflation in the June quarter. Inflation is forecast to decline to around 3¼ per cent by the end of 2024, and to be within the target range at 2¾ per cent by the end of 2025.

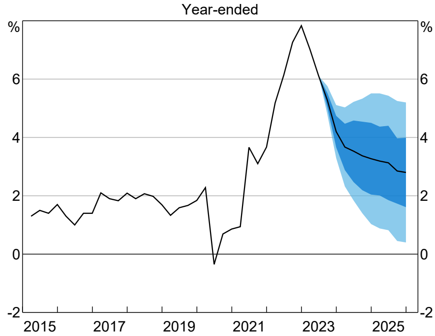
As has been the case for some time, energy prices are forecast to add significantly to inflationary pressures over the coming year. The average change in household and business electricity prices remains uncertain; however, the impact of increases in electricity prices on the CPI will be partially offset by government rebates under the Australian Government's Energy Price Relief Plan and various state government initiatives. Electricity prices are forecast to add around ¼ percentage point to headline inflation over the 2023/24 financial year, similar to the forecast three months ago.

Goods price inflation is forecast to moderate further in the period ahead as the easing in global upstream costs continues to be passed

Graph 5.1

Headline Inflation Forecast*

Year-ended



* Confidence intervals reflect RBA forecast errors since 1993, with the 70 per cent interval shown in dark blue and the 90 per cent interval shown in light blue.

Sources: ABS; RBA.

through to final prices amid slowing growth in demand. This is consistent with the experience in other advanced economies, albeit lagged. Firms in the Bank's liaison program have reported significant supply chain improvements and easing in some non-labour input cost pressures, most notably for international freight and some imported goods. Domestic cost pressures – such as energy, labour costs and logistics – remain a source of upward pressure in firms' pricing decisions, though these are expected to ease later in the forecast period.

Services inflation is forecast to remain high in coming quarters amid rising labour costs and a still-high level of demand, before easing gradually as demand moderates and generates spare capacity. Rent inflation is forecast to increase further over the period ahead as rental vacancy rates remain low, and as housing supply responds with a lag to population growth.

Underlying inflation is forecast to decline over coming years to be around 3 per cent by the end of 2024 (Graph 5.2). The decline in inflation over the remainder of 2023 is expected to be driven by the resolution of supply disruptions and slower growth in demand (Graph 5.3). Ongoing tightness in the labour market and energy price increases are expected to keep domestic price pressures elevated in the near term before they start to ease later in the forecast period. There remains a high degree of uncertainty around the speed and extent of the decline in inflation expected in the period ahead. On the one hand, lower goods price inflation from the resolution of supply chain issues could come through sooner and swifter than anticipated. On the other hand, domestic price pressures may be stronger and more persistent than expected. These risks are discussed further in the section on 'Key domestic uncertainties' below.

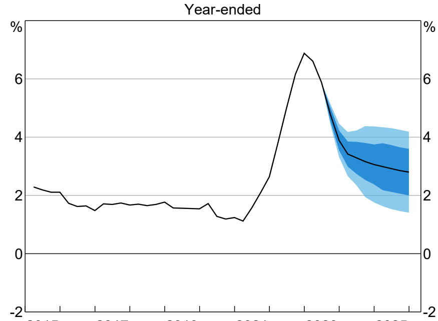
Economic growth is expected to be weak in the period ahead

GDP growth is forecast to remain subdued over the rest of 2023, with GDP per capita declining over this period (Graph 5.4). The soft near-term outlook reflects subdued growth in household consumption as higher interest rates and cost-of-living pressures weigh on real disposable income. However, higher household net wealth – reflecting the recent increase in housing prices – is forecast to provide some support. Ongoing capacity constraints and weak demand for new housing are forecast to weigh on dwelling investment until mid-2024.

Graph 5.2

Trimmed Mean Inflation Forecast*

Year-ended



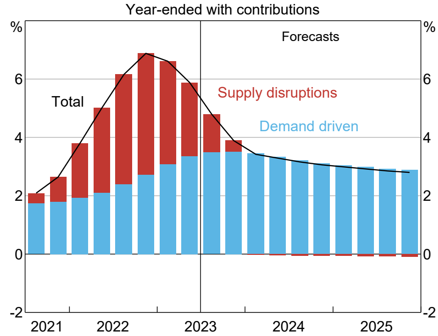
* Confidence intervals reflect RBA forecast errors since 1993, with the 70 per cent interval shown in dark blue and the 90 per cent interval shown in light blue.

Sources: ABS; RBA.

Graph 5.3

Trimmed Mean Inflation

Year-ended with contributions



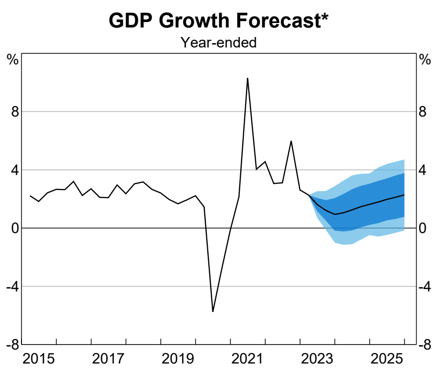
Sources: ABS; RBA.

GDP growth is forecast to increase gradually from early next year, supported by household consumption and public demand. Household consumption growth is forecast to increase to around its pre-pandemic average, supported by a recovery in real income growth and a pick-up in household wealth. Exports will continue to be supported by the rebound in tourism and solid growth in education-related travel.

Consumption growth is forecast to remain subdued in the near term

Household consumption growth is forecast to remain subdued over coming quarters (Graph 5.5). This reflects weak growth in real disposable incomes as the strong growth in labour incomes is being more than offset by high consumer price inflation, the earlier tightening in monetary policy and higher tax payable. Consumption growth is forecast to pick up to around its pre-pandemic average by late 2024 and remain around that rate over 2025. The increase in consumption growth is expected to be supported by a fading in the current headwinds to real income growth as inflation declines, interest rates are assumed to be past their peak and growth in household wealth picks up. The 'Stage 3' tax cuts will also support income and consumption from mid-2024.

Graph 5.4



* Confidence intervals reflect RBA forecast errors since 1993, with the 70 per cent interval shown in dark blue and the 90 per cent interval shown in light blue.

Sources: ABS; RBA.

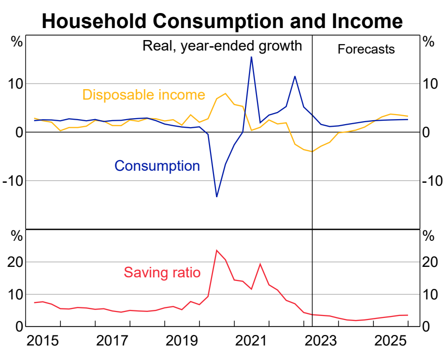
The household saving ratio is forecast to continue to decline over the next year or so, before increasing gradually from mid-2024.

The outlook for private investment has softened but remains positive

Labour shortages are expected to continue weighing on the pace of residential and non-residential construction throughout the rest of 2023. Shortages of finishing trades – such as internal fitters, tilers and painters – have been a significant constraint on firms' ability to work through the large existing pipeline of residential construction. Some firms have been experiencing cash flow issues and insolvencies have risen in the construction sector, which may result in further delays to project timelines.

Further out, capacity constraints are anticipated to ease, and firms will continue to work through the existing pipeline of residential and non-residential construction work to be done. Although demand for new housing has been weak, strong population growth and higher housing prices are expected to support a recovery in demand and residential construction activity over coming years. While strong inward migration and high rental yields will support demand for new dwellings, higher density housing supply typically responds with a significant lag due to long planning and construction lead times. After gaining planning

Graph 5.5



Sources: ABS; RBA.

approvals and pre-sales, the average apartment building takes more than two years to build.

Non-mining machinery and equipment investment is forecast to remain at an elevated level in the near term, consistent with information from the ABS Capital Expenditure Survey, before easing further out. Mining investment is forecast to grow over the rest of 2023, before easing slightly as work on expansionary iron ore and oil and gas projects winds down. The majority of mining investment currently underway remains sustaining in nature and is intended to replace ageing infrastructure.

Public demand is expected to grow

Public consumption is forecast to increase modestly over the remainder of the year, with lower pandemic-related spending offset by temporary expenditures on electricity rebates. Further out, the expansion in public consumption will be supported by public spending programs such as the National Disability Insurance Scheme and aged care.

The existing pipeline of public infrastructure work is anticipated to support a high level of public capital expenditures for several years, although the speed of the rollout will continue to be affected by capacity constraints in the construction sector in the near term.

Education and travel will drive growth in exports

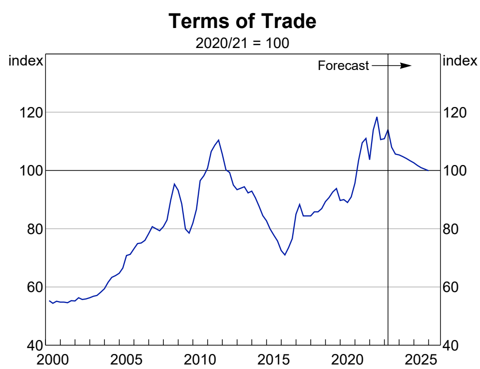
Export volumes are forecast to continue to grow modestly over coming years, driven by services exports. The number of student visa holders in Australia is around its pre-pandemic level and is expected to continue growing strongly, consistent with pre-pandemic trends. Overseas tourist arrivals are around 80 per cent of their pre-pandemic levels and are also expected to continue growing strongly as airline capacity returns. Resource exports are expected to grow slowly, supported by a recovery in coal exports in the near term and small expansionary iron ore projects further out in the forecast period. By contrast, rural export volumes are forecast to decline as growing conditions deteriorate following an exceptional couple of years. Warmer and drier conditions are expected over the latter part of the year amid an increased likelihood of an El Niño event, which is generally associated with lower-than-average rainfall across the eastern seaboard of Australia.

The terms of trade are expected to fall in the June quarter, driven by a sharp decline in coal prices (Graph 5.6). The terms of trade will then continue to decline over the remainder of the forecast period as commodity prices fall, though this will be partly offset by a gradual easing in import prices as supply chains improve.

The unemployment rate is forecast to increase as economic growth slows

Employment growth is forecast to moderate over the remainder of this year as a result of a period of subdued economic growth and an associated softening of labour demand (Graph 5.7). In addition, hours worked have been a key margin of adjustment to labour demand and have grown by more than employment since the start of the pandemic; average hours worked are forecast to decline from now onwards as part of the expected labour market

Graph 5.6



Sources: ABS; RBA.

downturn. Participation in the labour force is expected to be sustained around historically high levels over the forecast period. The effect of the cyclical slowing in the labour market is expected to be partly offset by the continuing of the current trends of higher participation by female and older workers.

Labour market spare capacity remained around multi-decade lows in the June quarter, though a broad range of measures suggest the labour market is not as tight as it was in late 2022. Labour underutilisation (as measured by the unemployment rate and by people working fewer hours than they want) is expected to gradually increase as labour demand moderates while the labour force continues to grow; population growth supports growth in labour supply while also adding to aggregate demand in the economy. That said, the unemployment rate is expected to remain below pre-pandemic levels throughout the forecast period (Graph 5.8).

Wages growth is expected to increase further

Timely indicators suggest that wages growth was steady in the June quarter ahead of the implementation of the Fair Work Commission's (FWC) award and minimum wage changes in July. Firms in the Bank's liaison program report that their current wages growth and year-ahead expectations were steady at around 4 per cent in the June quarter. Market economists and unions expect wages growth to be 3½ to 4 per cent over the year ahead, before moderating over 2024/25.

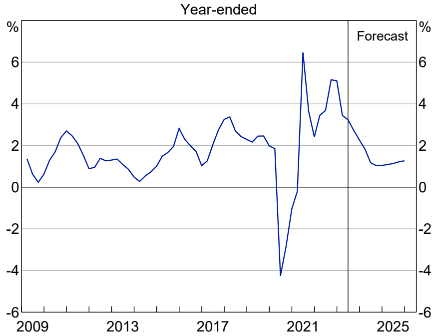
Year-ended growth in the Wage Price Index (WPI) – which measures changes in base wage rates for a given quantity and quality of labour – is forecast to be 4 per cent in the second half of 2023, before declining gradually to around 3½ per cent by the end of 2025 (Graph 5.9). The near-term outlook is slightly stronger than a few months ago. Developments in government wage policies in several states, the annual minimum and award wage decision by the FWC and the 15 per cent wage increase for aged care workers will support wages growth over the rest of the year. WPI growth is then forecast to ease at a gradual pace over 2024 and 2025 as spare capacity in the labour market increases and inflation declines. Inertia in the wage-setting process and some lagged catch-up in real wages mean the decline in wages growth is forecast to be slower than the decline in inflation (Graph 5.10).

Broad measures of labour income are expected to grow at a faster rate than the WPI over the first part of the forecast period, as employers use

Graph 5.7

Employment Growth

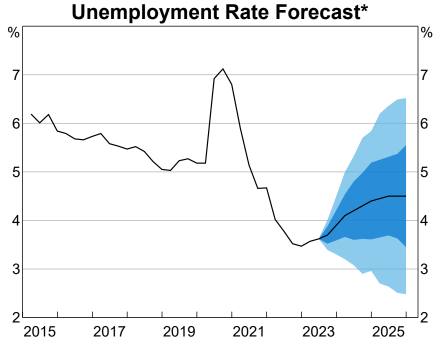
Year-ended



Sources: ABS; RBA.

Graph 5.8

Unemployment Rate Forecast*



* Confidence intervals reflect RBA forecast errors since 1993, with the 70 per cent interval shown in dark blue and the 90 per cent interval shown in light blue.

Sources: ABS; RBA.

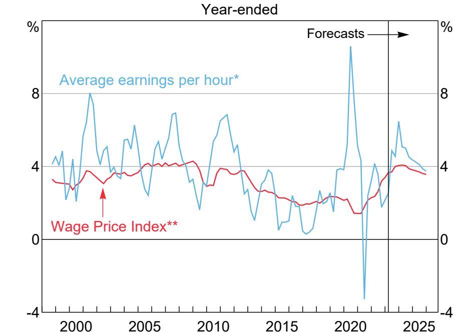
bonuses, allowances and other non-base wage payments to retain or attract staff. These broader measures imply less of a decline in real wages than suggested by the WPI measure. As labour market conditions ease, the gap between growth in the WPI and broader labour cost measures is forecast to close.

Recent labour productivity outcomes have remained weak. Together with solid growth in average earnings in recent quarters, this has seen year-ended growth in unit labour costs reach its highest level since 1990 (excluding pandemic-impacted outcomes in 2021). The forecasts for labour income remain consistent

Graph 5.9

Wages and Earnings Growth

Year-ended

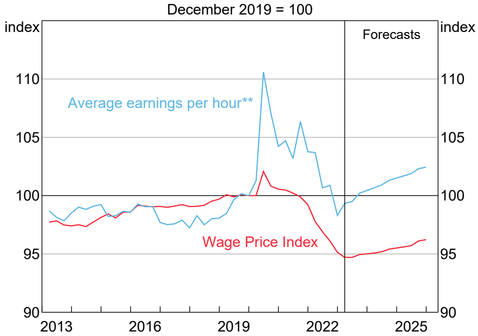


* Non-farm; includes social contributions.
** Excluding bonuses and commissions.
Sources: ABS; RBA.

Graph 5.10

Real Labour Income*

December 2019 = 100



* Deflated using the headline Consumer Price Index.
** Non-farm.
Sources: ABS; RBA.

with the inflation target, provided productivity growth returns to its pre-pandemic trend.

Key domestic uncertainties

The outlook for China is uncertain

China's uneven recovery from COVID-19 restrictions has created uncertainty around the outlook for demand for bulk commodities and, in turn, the prices of Australia's key exports and terms of trade. Demand for residential property in China has weakened significantly. This could lead to an even more prolonged downturn in real estate investment and lower steel demand. By contrast, policy measures to stimulate the property sector, if broad in scale and impact, could increase the prices of bulk commodities in anticipation of stronger steel demand.

Consumer confidence in China remains subdued and heightened economic uncertainty could lead to enduring incentives for households to prefer saving over discretionary consumption. If consumption growth settles at a lower trend, this poses additional downside risks to Australia's exports to China, including for education and tourism services as well as consumer goods. Moreover, if China's overall growth settles at a lower rate than expected, this could further weigh on Australia's exports through its effect on the rate of economic growth in Australia's major trading partners in the east Asian region.

The outlook for household consumption is subject to competing forces

The outlook for household consumption remains a key uncertainty for domestic activity. The stronger outlook for wealth could lead to a larger turnaround in household consumption growth than currently expected, including via increased housing turnover and increased ability to obtain credit. In addition, many households built up liquid savings buffers during the pandemic that they can draw upon in the current environment; spending could be stronger than anticipated if households are willing to spend more from these savings than expected. This would be reflected in a larger fall in the household savings ratio. The resilience of the labour market to the slowdown in domestic activity could, if sustained, contribute to stronger-than-expected outcomes for household incomes and consumption. The realisation of these stronger outcomes would result in domestic inflationary pressures easing by less than expected.

Weakness in household consumption could persist for longer than expected if weak real disposable income growth has a larger-than-expected effect, particularly on low-income households that typically have lower savings buffers. Many households are well placed to absorb higher interest rate costs without significant adjustments to spending. However, there is a risk that households, especially those with low savings buffers and high debt relative to incomes, will adjust by more than expected in response to higher interest rates. Higher interest rates could also encourage households to save more than expected, which would affect consumption.

Inflation could be more persistent than expected

Underlying inflation is expected to take a couple of years to return to the inflation target range. However, it is possible that the easing in inflation takes longer than this. Services inflation is expected to remain elevated over the forecast period – taking signal from the persistence being experienced overseas – but there is a risk that it remains stubbornly higher than forecast. In a high inflation environment, it is easier for firms to increase prices; people also tend to pay closer attention to changes in costs and prices than when inflation is low, and so may come to expect further large price increases. While margins outside of the mining sector have been broadly stable in recent years, firms may expand their margins as costs ease if demand remains sufficiently strong. Alternatively, there could be stronger feedback between wages and prices. Large increases to minimum and award wages and the lifting or removal of wage caps by state governments could also have greater spillover effects on the wages of other workers than currently expected, especially if they become a benchmark for wage negotiations more broadly. In these events, inflation would be persistently higher throughout the forecast period, which increases the risk that inflation expectations become de-anchored.

Inflation could also be more persistent if productivity growth does not pick up, which would make the current outlook for nominal wages more inflationary than expected. The forecasts include an expectation that productivity growth increases to the rate recorded in the years preceding the pandemic. Productivity growth since the beginning of the pandemic has been weaker than this – in fact, measured productivity does not appear to have increased at all since 2019 – although the pandemic has made it difficult to discern underlying trends.

Rent inflation could also be higher and more persistent than expected. Strong population growth is occurring at a time when the rental market is already very tight and it will take time for supply to respond. Higher rents are likely to encourage the average number of people living in each dwelling to increase, which would be a reversal of the decline that occurred during the pandemic as people sought more space. Conversely, further reductions in household size would put further pressure on the rental market through higher prices and lower vacancy rates.

Goods prices could decline significantly

The inflation forecasts assume that goods prices stabilise at a high level rather than decline over coming years. Supply chain conditions are back around pre-pandemic norms and goods inflation has eased in most advanced economies. Large or widespread declines in goods prices would moderate inflation outcomes by more than currently expected. One way this could occur is if the simultaneous tightening of monetary policy across many economies affects demand by more than the sum of individual-economy effects would imply. To give a sense of the magnitude of this risk, if prices for consumer durables reversed one-third of the price increases recorded since the onset of the pandemic, year-ended headline inflation would be around ½ percentage point lower than the current forecast. This would mean that headline inflation would be around the middle of the inflation target range in 2024, instead of being above it.